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Market Outlook

INVESTMENT FOCUS

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2023 Recap: Time Heals *Some* Wounds

12 months ago, growth stocks had declined 30%+, inflation and interest rates were near decade highs, and nearly every Wall Street strategist was calling for a recession. There were many reasons to be bearish, including a deeply inverted yield curve and other popular recession forecasting metrics that were all flashing red, an ongoing Russian/Ukraine war, and rapidly increasing Federal government debt that was believed to be a headwind to growth. Inflation was also thought to be structurally higher due to an aging workforce, deglobalization, and persistently higher energy prices resulting from supply constraints.

In March, two of the top 20 U.S. banks failed[1] when investors realized that depositors are actual liabilities, and when those depositors don't get paid higher rates as short-term interest rates increase, they can leave with a push of a button on a smartphone. The Fed stepped in and created new programs to ensure banks had enough liquidity to prevent additional bank runs. In effect, this also paused monetary tightening and gave banks time to shore up their liquidity. This also proved to be a short-term bottom in equity markets as investors realized that this wasn't 2008 over again and markets moved higher into the summer, led by large-cap growth stocks.

The bearish tone remained though, as the focus shifted to the 'narrowness' of the market – meaning, the "Magnificent 7" were rebounding and leading the market higher, while the remaining 493 companies in the S&P 500 languished.[2] These concerns were compounded when longer-term interest rates spiked during the summer after the Treasury Department announced the funding schedule for the second half of the year showing much more debt issuance than the market had expected.[3] This kicked off a multi-month stock and bond market decline that was exacerbated by geopolitical turmoil and humanitarian disasters in the Middle East.

However, optimistic sentiment quickly returned late in the year as employment remained firm and inflation data confirmed that the Fed could finally pause interest rate hikes and investors began pricing in cuts in 2024 that might buoy economic activity and support asset prices.

2024 Outlook & Opportunities

The year ahead will undoubtedly challenge consensus thinking – which has now swung from overly cautious to outright bullish. Through the ups and downs of asset prices, our focus remains on building diversified portfolios of stocks, bonds, and alternative investments that help our clients reach their long-term financial goals.

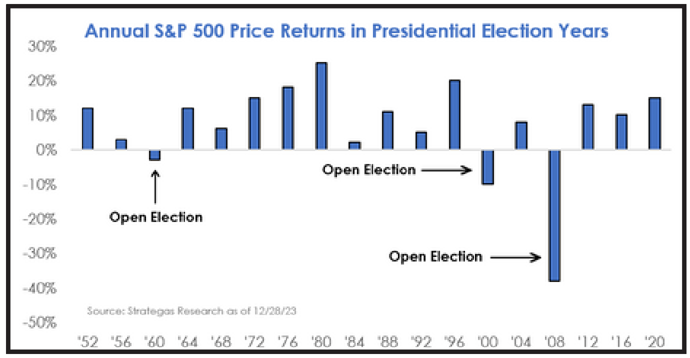
The 60/40 portfolio was first proposed in the early 1950s and has generally been successful in providing diversification benefits. The 60/40 portfolio returned -18% in 2022, the worst return in 70 years. There were only seven other down years for the 60/40 portfolio with the last down year in 2008 (-14%) (Source: S&P 500, 10-year Treasury, NYU). Despite this track record, the financial press and many others maligned the 60/40 portfolio suggesting it was outdated and that "this time is different." While we aren't anchored to the 60/40 portfolio, we believe it is a valuable starting point for building client portfolios that can then be customized for specific needs.

While the drumbeat of 'sticky' or 'structurally higher' inflation has quieted, we aren't convinced that inflation will remain calm in the year ahead. Oil prices could surge, especially if the Middle East tensions broaden, the Fed could loosen monetary conditions too quickly, or the economy could prove much stronger, which would all likely result in higher inflation and pressure the 60/40 portfolio. However, we expect the portfolio to continue to play an important role for clients over the long term and doubt the saying "this time is different."

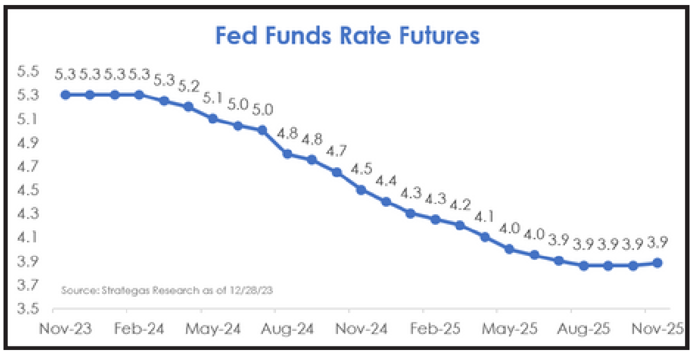
There are also two important market cycles that we are monitoring closely: the Presidential cycle and the Fed cycle.

The Presidential Cycle

The equity market has the presidential cycle on its side in 2024. Since 1952, the S&P 500 market index has not declined in a year in which an incumbent president was running for re-election. Stocks have declined in presidential election years, but in each of those cases, it was a year in which there was an open election with no incumbent running (1960, 2000, and 2008) as Presidents want to be re-elected and will use whatever policy levers are needed to lift the economy (see chart). In fact, during this period every president who avoided a recession two years before their re-election went on to win the election, and every president who had a recession in the two years before their re-election went on to lose.



The Fed Cycle



With the hard part of the inflation fight now likely over, and the labor market in the process of rebalancing as job openings decline without a meaningful rise in unemployment, the Fed and most major central banks are now likely finished hiking rates and are entering a new period of rate cuts. The market is pricing in five rate cuts in 2024 (see graph), more than the three that the Fed implied at its most recent December meeting. While we believe market expectations are a little too optimistic and don't fully reflect structural influences playing out, we are encouraged by the direction inflation and labor markets are going and see the Fed Cycle as supportive of higher stock and bond prices.

High Interest Rate Regime

We expect rates to moderate in 2024 with the next phase of the Fed cycle, but we believe rates will remain well above ~2.5%, the average of the last ten years.

After the 2008 Global Financial Crisis (GFC), the Federal Reserve and other global central banks brought interest rates down to support economic growth, and they were able to keep rates low due to the long-term disinflationary effects of the crisis. This unusual interest rate regime came to an end when massive federal stimulus associated with the COVID shutdown, combined with supply chain disruptions, reignited inflation.

Since then, we have seen interest rates move steadily higher as the Fed combats inflation to where rates are now roughly at the same level they were before the GFC (see chart). Interest rates have recently come off their recent highs with inflation moderating and the expectation of Fed rate cuts in 2024, but we expect them to stay higher for longer because of the following reasons:

- Record deficits and related funding costs.
- Demographic imbalances in the labor force that support faster wage growth.
- Roughly $3 trillion[4] of 'excess' money that supports continued consumer spending.
- Historical inflation trends that show inflation usually come in waves.

We believe these structural factors also result in a somewhat slower economic growth environment and one where the competition for investor capital also supports a more balanced investment approach.

WHAT WE ARE DOING:
We are positioned for income and potential appreciation in corporate and higher-quality municipal bonds, where tax-equivalent yields for higher tax bracket investors are as good as we have seen in a long time. We are also maintaining a position in shorter duration high yield bonds due to positive credit trends from healthy balance sheets and falling supply of these bonds in the higher interest rate environment.

Deglobalization

Globalization peaked before the GFC in 2008 and the COVID pandemic accelerated trends toward friend-shoring and near-shoring, where companies move supply chains to friendlier or closer geographies. Chinese supply chains are deeply rooted in complex infrastructure that can take many years to relocate. For example, Apple is deliberating moving its supply chain out of China, but it will likely be a decade before any meaningful relocation is completed. While smaller and less complex companies can be nimbler, for larger companies such as Apple, the process has been referred to as 'slowbalization' because relocating supply chains is challenging, expensive, and fraught with risks.

WHAT WE ARE DOING:
We anticipate the geopolitical landscape to remain complex and challenging as evidenced by tensions arising in the Middle East and the ongoing overhang of China's incessant provocations of Taiwan. We cannot accurately forecast geopolitical risk or their ensuing market impacts, but we can minimize risk where appropriate. In emerging markets, we have limited exposure to Chinese companies and are overweight India and other countries aligned with the U.S. for better growth, higher quality companies, and limited geopolitical risk. In developed markets, both foreign and domestic, we see opportunities in owning industrial companies or other similarly situated companies that are benefiting from reshoring trends.

Innovation

The resiliency of the U.S. economy can, at least partially, be attributed to innovation, which for hundreds of years has been a hallmark of U.S. excellence. As Bill Gates suggested, most people overestimate the near-term benefits of an innovation but underestimate what can be achieved in ten years. Artificial intelligence is not new but reached an important tipping point this year that is forcing companies globally to assess how AI can positively impact their business.

Because AI requires massive amounts of data and sophisticated infrastructure to run large language models, the initial AI beneficiaries are the mega-cap technology companies that have the scale, the balance sheet, and the resources to invest in products and services to leverage AI. However, over time we expect the beneficiaries to broaden as new services are brought to the market and private companies with specialization come public via IPOs. We can also envision a scenario in which non-tech companies benefit from improved margins and faster earnings growth as productivity is enhanced by incorporating AI in their business models.

Innovation is also evident in health care. While many large-cap pharmaceutical companies face sluggish growth due to product portfolios that are coming off patents, biotechnology and medical device companies continue to innovate and create novel products that are either reducing costs or improving healthcare outcomes. Gene editing technology was first discovered over a decade ago, but only in late 2023 did the first gene editing therapy using CRSPR/Cas9 technology receive approval in the U.S. for treating sickle cell disease. CRSPR/Cas9 targets specific mutated genes that cause diseases and essentially reverses the mutated gene back to its 'healthy' state (which is often hereditary). By directly repairing the gene, the therapy is curative (and if it is hereditary, it is no longer passed on). While the technology is still in its infancy, over the next 10+ years, we anticipate many new gene editing therapies to be approved.

WHAT WE ARE DOING:
Despite our optimistic view of the mega-cap technology companies, we are slightly underweight due to valuations, market positioning, and sentiment. We would likely opportunistically add weight to our existing technology holdings if a market correction gave us an opportunity. In health care, we are overweight the sector as we view valuations relative to growth as attractive. Moreover, health care tends to be more economically resilient (if we were to see an economic slowdown) and has a structural tailwind from aging demographics.

Closing Thoughts

We expect economic growth, especially in the U.S., to remain resilient, risks associated with inflation to persist, and ten-year interest rates to remain above the past ten-year average of ~2.5%. Consensus has clearly shifted toward a "soft landing" as there appears to be far fewer calls for a recession by Wall Street strategists. Being aligned with consensus is always worrisome but we have no compelling reason to dispute this view. The Presidential cycle and the Fed cycle are two tailwinds for stocks but would also note that stock valuations relative to growth rates and interest rates are slightly elevated. Innovation remains a hallmark of U.S. economic resiliency and the unrelenting forces of entrepreneurship and creative destruction continue to move our economy forward, despite the Washington D.C. dysfunction.

Our focus remains steadfast on building portfolios of stocks, bonds, and alternative investments that help our clients achieve their long-term financial goals. Markets are risky and there are always market corrections. We are humbled and grateful that you have trusted us to help navigate these markets, and we undertake this responsibility with utmost care and consideration.

Sources : 1. https://www.fdic.gov/bank/historical/bank/bfb2023.html 2. Bloomberg pulled as of December 28, 2023 3. https://home.treasury.gov/news/press-releases/jy1662#ftn2 4. New York Federal Reserve as of December 28, 2023