Quarterly Market Commentary

Fourth Quarter 2023

Ring Them Bells

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"Ring them bells for the blind and the deaf
Ring them bells for all of us who are left
Ring them bells for the chosen few
Who will judge the many when the game is through"

- Bob Dylan, *Ring Them Bells*

The Powell Pivot

The bell heard following the Federal Reserve Open Market Committee's (FOMC) meeting on November 2nd sounded a lot like a dinner bell for the bulls on Wall Street. The meeting's minutes showed a slight deviation in language, with Committee members suggesting we are moving from a period that required "sufficiently restrictive" monetary policy to reduce inflation, to a period where the FOMC believes it can "proceed carefully on the totality of incoming information and its implications for the economic outlook." A subtle, but effective change in messaging. The dovish outlook continued when the Committee released their "dot plot" (committee member's forecast for future interest rates) by projecting three 0.25% interest rate cuts by the end of 2024. The slight change in language and small reduction in projected policy rates was all the market needed to surmise the Fed's game of interest rate hikes was through.

The S&P 500 responded with a 9-week win streak, rising +16% over the final two months of the year. With an end to restrictive policy in sight, investors across asset classes responded with a broad and powerful rally to finish 2023.

Quarter To Date as of December 31, 2023[1]	
S&P 500 Total Return Index	11.7%
Dow Jones Industrial Average	13.1%
Nasdaq Composite Index	13.6%
Russell 2000 Index	14.0%
MSCI EAFE Index	10.5%
MSCI Emerging Markets Index	7.9%
Bloomberg Aggregate Bond Index	6.8%

Inflation: Mission Mostly Accomplished

With the Consumer Price Index (CPI) currently sitting at 3.1%, still well above the Federal Reserve's target, most market strategists were caught off guard by "The Powell Pivot." What, you might ask, provides the Fed confidence to downshift interest rate policy at this time? A few things:

1) *Disinflation*: The US, and other developed economies have experienced a substantial decline in inflation from their peak levels. CPI in the US was nearly 6% in June 2023, and has been cut in half over the last 3 months.

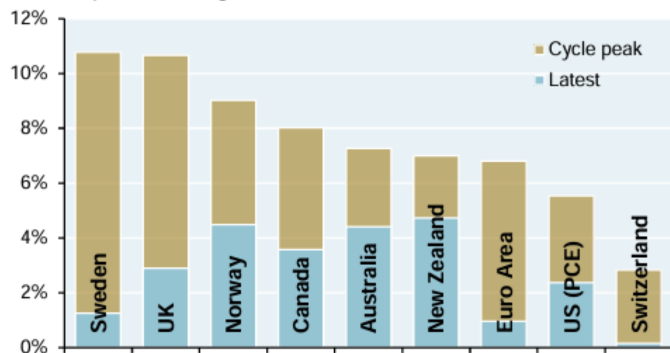
2) *Easing Supply Chain Pressures*: Supply chain bottlenecks resulting from the pandemic impacted new and used autos, freight costs, and access to key components. Debottlenecking these supply chains has led to a more normalized price environment.

3) *Shelter Costs*: Rising shelter costs – specifically Owner's Equivalent Rent – has been a persistent problem over the past 18 months. With an

[1] Black Diamond

increased supply of multi-family housing coming to market and a leveling of home price growth in 2023, shelter inflation has slowly come down.

Core Inflation Declines by Country[2]

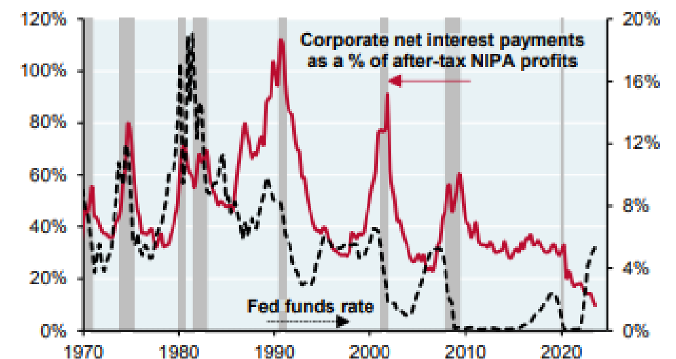


The Federal Reserve communicated an expectation to cut interest rates three times in 2024, or 0.75%. However, the Fed Funds Futures market is currently pricing in twice that, or six interest rate cuts and a reduction of 1.4% by year end. Financial assets enjoy lower interest rates, but the unspoken risk is that the Fed cuts too much too quickly, leading to a resurgence in demand, and potentially, a resurgence in inflation. After all the work that has been done to stomp out inflation, another wave of rising prices would be a troubling prospect for the stability of markets and the credibility of the Fed.

Recession Averted in 2023

Contrary to consensus forecasts, the fastest rate hiking cycle in modern history did not lead to a recession. While the case for economic resiliency was difficult to make at the turn of 2022, there were some undercurrents of strength that kept the economy afloat. Unlike prior recessions, corporate cash flows remained in good shape – paradoxically due to rising prices. Furthermore, corporate balance sheets were largely unaffected by higher interest rates, as companies termed out debt when interest rates were at historic lows. Though earnings growth was flat for the year, the low-cost debt helped companies avoid bankruptcies, which often precede job losses and recession.

Corporate Net Interest Costs[3]



The strain of inflation on consumers has been well-documented. According to data from the Federal Reserve, excess savings households built during the pandemic have officially been spent, with bank accounts normalizing to 2019 levels. Food insecurity data and hardship withdrawals from 401k's are at rates not seen since the Great Recession. And finally, credit card balances remain at all-time highs, despite the interest expense on those balances hovering near 23%.

Yet, despite the higher costs of goods and services, a higher cost of capital, and a generally challenging financial situation for most households, consumers did what they do best—consume. Individuals who wanted a job could acquire and maintain one, or even hold several jobs should they choose. More importantly, after almost 20 years of stagnating wages, income growth held at multi decade highs with employers attempting to avoid the labor crunch they endured in 2021 and 2022. The combination of steady employment and growing wages have buoyed household finances and helped to absorb higher prices imposed by inflation.

[2] Haver Analytics, JP Morgan Asset Management

[3] Bloomberg, JP Morgan Asset Management

Looking Ahead to 2024

Falling inflation and prospects for an easier Fed have fueled investors' "animal spirits." As we approach 2024 following the year-end rally, the question remains: what happens from here? Our view is that economic growth will continue to slow throughout the first half of the year, though is unlikely to result in recession. If recession does occur, it will likely be mild given the economic resilience previously discussed. This risk is further buffered by a Federal Reserve who now appears ready to cut rates and provide liquidity should it be necessary.

The challenge for investors in 2024, however, is that the market has priced this optimistic view into asset prices extremely quickly. Equity valuations are high vs. historical averages at 19x NTM earnings, and the 10-year treasury yield retreated almost 1% over the final two months of the year to 4.00%. With asset values where they are, a lot needs to go right in the new year to support current prices. A benevolent Fed, continued disinflation, a resilient economy, and a resumption of earnings growth are all baked into current expectations.

There is an old saying on Wall Street: "Nobody rings a bell at tops or bottoms." Well, a bell was rung at the end of 2023 – we will find out if it was in fact a bottom, a top, or, perhaps, just a catchy Dylan song.

As always, we appreciate your trust and partnership as we navigate markets together. If you have any questions or concerns, please don't hesitate to reach out to us.

Respectfully,

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The impact of the outbreak of COVID-19 on the economy is highly uncertain. Valuations and economic data may change more rapidly and significantly than under standard market conditions. COVID-19 has and will continue based on economic forecasts to have a material impact on the US and global economy for an unknown period.