

Quarterly Market Outlook

January 2024

The Big Picture

The 2010s was a period of record-low interest rates, dismal wage growth, low inflation and economic stagnation. Covid changed all that, as coordinated monetary and fiscal stimulus fueled consumption, turbocharged growth, and sent inflation, wages and financial assets soaring in 2021. The Fed responded in 2022 with aggressive tightening to rein in inflation, a headwind for all assets, which repriced in the face of higher discount rates and the end of free money. But with the tightening presumably behind us, we appear to have entered a “new normal,” where a healthier economy can support higher nominal and positive real interest rates. We expect these higher base rates to lead to more attractive returns longer-term, as risk assets generally price to deliver returns above the risk-free rate.

2023 vs. Expectations

A year ago, recession seemed almost inevitable. The Fed had embarked on the most significant tightening in four decades, hiking interest rates over 500 bps from zero (finally pausing at 5.25-5.5% last summer) and unwinding its balance sheet at a \$95 billion/month clip. Covid stimulus was behind us, excess savings were running out, housing appeared to have peaked, and inflation was still at 7%, with a tight labor market pushing wages higher even as the economy weakened. The conventional wisdom held that we were either already entering recession or that the Fed would essentially have to cause one, keeping rates “higher for longer” and driving up unemployment in order for price pressures to abate. Yet today, growth remains solid with inflation back at 3% and headed lower, and the Fed has all but declared “mission accomplished,” forecasting at least three rate cuts in 2024. What happened? ¹

A Less Rate-Sensitive Economy?

The economy turned out to be less sensitive to interest rates than many expected. For one, corporations and households were far less indebted than in 2008, and both had locked in record-low rates and termed out their debt during the pandemic, leaving them relatively insulated from rate hikes while earning attractive yields on cash. In addition, economic growth since Covid has been driven by stimulus, rising incomes and government spending – not private-sector borrowing – and spending has shifted back to services (which are less rate-sensitive than goods). Limited inventory has also supported the housing market. ²

An Immaculate Disinflation

Also contrary to expectations, inflation has fallen despite solid growth. Just as supply-chain bottlenecks caused inflation to surge, their resolution has brought it back down. Spikes in food and energy prices fueled by the Ukraine war have more than reversed – another disinflationary impulse – while increased labor-force participation, a surge in immigration post-pandemic, and falling job openings have cooled the labor market. With the supply of commodities, goods and labor rising amid moderating demand, price pressures have largely abated. ³

Markets Rebound

Most markets rallied in Q4 on the view that “higher for longer” was essentially off the table and the Fed now had room to ease sooner than expected. After peaking at 5.1% in October, the 10-year Treasury yield staged a major rally and is now back below 4%, and real yields on TIPS are back down to 1.7% from a peak of 2.5%. With discount rates lower and financing conditions looser, the S&P 500 surged 11.7% in Q4 to end the year up 26%, while the US Agg Bond Index rallied 6.8% to end up 5.5%. ⁴

The Magnificent 7

The market’s megacap darlings soared 76% in 2023, carrying the S&P 500 higher amid AI euphoria and helping growth beat value by a record 36%. While the broader market was barely positive for much of the year, it joined the rally in Q4 as rates fell, bringing “the S&P 493” return up to 13% by year end, with small-caps rallying 22% in November and December. ⁵

The Fed Pivot

In its final meeting of 2023, the Fed noted substantial progress in bringing the labor market back into balance and inflation back to target, signaling lower interest rates ahead – a major policy shift that reinforced the rally in financial assets. Critically, the Fed indicated that it could act preemptively, cutting rates “well before” inflation hits 2% to prevent policy from becoming too restrictive. ⁶

What’s Next?

Most economists expect a “soft landing” in 2024, with U.S. growth slowing to the mid-1% range from the 2-2.5% rate it’s averaged since 2020. Household assets are at record highs, sentiment has improved, higher wages should increase real incomes as inflation falls, and financial conditions have eased back to where they were in Q1 2022 – before the tightening even started – all of which should support growth. At the same time, manufacturing continues to weaken, credit-card and auto-loan delinquencies are rising (albeit from low levels), bank lending is declining, and higher interest expense will continue to impact segments of the commercial real estate and corporate lending markets as loans mature. In addition, the ongoing wars in Ukraine and the Middle East continue to threaten shipping routes and energy supplies, and broader escalation remains a risk. For now, though, the economy seems to be on solid footing. ⁷

Market Pricing and the Investment Landscape

Optimal conditions appear to be essentially priced in. The S&P 500 looks relatively expensive, with a forward P/E ratio of 20 and double-digit earnings growth projected for 2024 and 2025 – far higher than what is expected for the economy. And with the yield curve heavily inverted again, returns may be disappointing if the Fed eases less than markets expect. That said, both nominal and real yields remain well above where they were pre-Covid, and we believe balanced portfolios can earn reasonable returns over time. In addition, we believe private-market alternatives will remain a fruitful area for investment, particularly where the pullback in traditional sources of capital (e.g., banks) creates opportunities for managers to provide creative solutions on advantageous terms. ⁸

Notes

All data as of 12/31/23.

¹ Bloomberg (DOTS, FEDL01 Index, CPI YOY Index); Resilient U.S. Economy Defies Expectations – WSJ; Housing-Market Rebound Poses Challenge for Fed's Inflation Fight – Bloomberg; US retail sales beat expectations as Americans pay more for gasoline | Reuters; The Fed - An update on Excess Savings in Selected Advanced Economies (federalreserve.gov); Top economists unanimous on 'higher for longer' rates as inflation threats linger (cnbc.com); Fed minutes cite lower inflation risks, concern about 'overly restrictive' policy | Reuters.

² Why the U.S. economy is so immune to the Fed's rate hikes (axios.com); The Economy's Surprising Resilience Has Big Implications for Fed Interest Rates | Barron's (barrons.com); Why Has Monetary Policy Tightening Not Cooled the Labor Market Enough to Quell Inflation? - Federal Reserve Bank of Kansas City (kansascityfed.org); Home Buyers Are Ready to Buy, But Sellers Aren't Selling. - WSJ.

³ How Inflation Can Keep Falling – WSJ; Fed Begins Pivot Toward Lowering Rates as Inflation Declines – WSJ; For Much of the World, Inflation Will Be Normal in 2024—Finally – WSJ; Immigration and the Labor Market in the Post-Pandemic Recovery - Federal Reserve Bank of Chicago (chicagofed.org); US JOLTS Job Openings Eased in November to Lowest Since Early 2021 - Bloomberg.

⁴ Bloomberg (UGG10YR Index, GTI110 Govt, SPX Index, LBUTRUU Index).

⁵ Bloomberg (SPX Index, MSFT, AAPL, AMZN, NVDA, GOOGL, TSLA, META, SPTRSMCP Index, M1US000G Index, M1US000V Index); Evoke analysis.

⁶ Bloomberg (DOTS); Transcript: Fed Chief Powell's Postmeeting Press Conference – WSJ.

⁷ Bloomberg (ECFC, EHGDUS Index); The Fed - Chart: Balance Sheet of Households and Nonprofit Organizations, 1952 - 2023 (federalreserve.gov); Consumer Sentiment Rises as Inflation Cools Down (wsj.com); US wage growth, once an inflation risk, may be the prop a soft landing needs | Reuters; Markets Cheer Fed Outlook, but the Rally Complicates It – WSJ; Jobs, Manufacturing Data Suggest That the Economy Continues Cooling (wsj.com); Major US card issuers see November delinquency approximate early pandemic levels | S&P Global Market Intelligence (spglobal.com); Used Car Prices Drop As Negative Equity Slams Buyers – Bloomberg; 'Almost All Loans Are Bad'—Why Banks Aren't Lending – WSJ; The \$1 trillion 'wall of worry' for commercial real estate that spirals through 2027 – MarketWatch; Landlords with \$1.2 trillion of debt face rising default risk - Los Angeles Times (latimes.com); 'We're in the first inning of the commercial real estate correction,' billionaire real estate investor Jeff Greene says | Fortune.

⁸ YRI Earnings Outlook - Yardeni Research; Stock Market P/E Ratios - Yardeni Research; Bloomberg (USGG3M Index, USGG2YR Index, USGG10YR Index).

IMPORTANT INFORMATION

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