Market Review & Outlook

January 2024

What a difference a year makes! Economists had a consensus opinion coming into last year that the US would suffer a downturn in 2023. But here we are a year later and perhaps the most predicted recession in US history has yet to materialize. Gross domestic product grew at a faster-than-2% annual rate in the first half of last year, accelerated to 4.9% in the third quarter, and according to the Atlanta Fed's GDPNow model, grew at a 2.5% clip in the fourth quarter (estimate as of January 3). As for stocks, one can quibble about the health of the market internals, but based on the performance of the headline averages, 2023 can only be described as a resounding success, especially considering the gloomy outlook entering the year. For a more detailed look at how various asset classes performed in recent periods, please refer to the table below.

Index	Dec 2023	4th Qtr. Perfo-mance	One Year Perfor-mance	Description (what the index is comprised of)
S&P 500	4.45%	11.69%	26.29%	Large Cap US Stocks
DJ Industrial Average	4.93%	13.09%	16.18%	Large Cap US Stocks
Nasdaq Composite	5.58%	13.79%	44.64%	Large & Mid-Cap US Tech Stocks
Russell 1000 Growth	4.43%	14.16%	42.68%	Large Cap US Growth Stocks
Russell 1000 Value	5.54%	9.50%	11.46%	Large Cap US Value Stocks
Russell 2000 Growth	11.98%	12.75%	18.66%	Small Cap US Growth Stocks
Russell 2000 Value	12.45%	15.26%	14.65%	Small Cap US Value Stocks
MSCI EAFE	5.31%	10.42%	18.24%	Foreign Developed Market Stocks
MSCI EM	3.91%	7.86%	9.83%	Emerging Markets Stocks
Credit Suisse High Yield	3.51%	6.79%	13.55%	US High Yield Corporate Bonds
Bloomberg US Aggregate Bond Index	3.83%	6.82%	5.53%	Primarily U.S. Government Bonds plus investment grade corporates

For growth stocks, and especially the tech-heavy Nasdaq, gains were front-loaded in the first half of last year, as the Nasdaq posted its best first half in 40 years. However, stocks fell 10.3% from August through October as interest rates climbed and the US dollar strengthened. Financial conditions tightened considerably throughout those three months until interest rates started to drop sharply in late October. That drop, in combination with better-than-expected October inflation data, kicked off an "everything" rally that received an additional boost from Jay Powell's suggestion at the December Fed meeting that three interest rate cuts are on the table for 2024.

The strong year-end rally propelled all the major averages to finish 2023 near their highs for the year, though the Dow Jones Industrial Average was the only index to finish at an all-time high (the S&P 500 came close). The sharp decline in interest rates near year-end also meant that bonds posted their first positive year since 2020. Moreover, many of the stock sectors that had languished throughout the year powered higher over the past two months, whereas the first 10 months of 2023 was mostly a story about the "Magnificent 7" technology stocks.

The year-end strength not only emboldened investor psychology but has many economists downgrading their previous recession forecasts to a "soft landing" or even "no landing" scenario, with the latter meaning some are not even forecasting a meaningful slowdown in growth. On the other hand, unless one ignores historically important recession indicators, the resurgence in optimism may be premature. To wit, through November, the Conference Board's index of leading economic indicators (LEI) has declined for 20 consecutive months, the worst such decline since the Great Financial Crisis. Furthermore, the yield curve has been inverted since July 2022, and yield curve inversions have accurately foreshadowed all 10 recessions since 1955, according to data from the San Francisco Fed, with only one false positive in the mid-1960s.

Of course, "this time could be different," a mantra heard from the financial community at various inflection points in modern economic history. As we've stated in recent missives, the massive amounts of government

spending during the post-Covid era combined with extraordinary monetary policy means this time really could be different. For example, the previous longest LEI negative streak without a recession was 10 months into January 2008. Then, the Great Recession began. Historically, most recessions begin after a negative streak of 5 or 6 months. However, the LEI model failed to see the negative GDP quarters in Q1 and Q2 of 2022, and further, the current negative streak started four months after GDP started contracting in 2022 and has not stopped contracting. As presently constructed, the LEI model accurately predicted the economy's coming trend for 60 years (1960 to 2020). But since the lockdown/restart recession of 2020, this has not been the case, suggesting that something meaningful has changed in the dynamics of the economy over the past several years.

Even so, we and others do not believe the "coast is clear" on the recession front just yet. For example, the world's largest bank, JPMorgan, thinks 2024 presents a challenging macro backdrop for the stock market, and has a 4,200 year-end price target on the S&P 500 (currently ~4,700), with a downside bias to that target. JPMorgan's fixed income team also believes we will experience a mild recession this year. Liz Ann Sonders, the chief market strategist of Charles Schwab, stated recently that the US economy has already been experiencing what she calls "rolling recessions," with different segments of the economy having already been in contraction. Moreover, she thinks a broader-based recession is still a possibility. It is unusual that the price of oil, perhaps the most economically sensitive commodity, has declined ~25% over the past three months not only at a time of perceived economic strength, but during geopolitical turmoil in the Middle East that would normally keep oil prices elevated. This suggests the drop in oil prices is a decline in demand (i.e., recessionary) story. The magnitude of the recent decline in interest rates is also unusual if the economy is in fact strong.

Regarding the outlook for stocks, crazier things have happened, but it's hard to envision technology stocks (especially the Magnificent 7) continuing to post the gargantuan gains they did last year, which was the best for the Nadaq 100 since 1999. A common saying on Wall Street is that at the end of the day, stock prices reflect underlying company earnings. Therefore, does it make sense that Apple rose 48% last year against a backdrop of four straight quarters of flat to declining revenues and profits? The narrow leadership at the top of the market is best exemplified by the fact that the median stock in 2023 underperformed the S&P 500 return by ~ 16 percentage points, the largest such disparity since 1999, the year before the dot.com bubble began to crash. On the other hand, while most analysts believe technology stocks are overvalued and due for a correction, this belief is not widely held about the rest of the stock market. Still, with the tech sector comprising almost 30% of the S&P 500 (2nd highest since the dot.com bubble era), even if other sectors do well, the headline averages could struggle if the tech sector doesn't at least tread water.

US stocks have broadly outperformed foreign stocks for many years, but perhaps this is starting to change. In his 2024 market outlook, Schwab's Jeff Kleintop remarked that the median foreign stock outperformed the median US stock for most of 2023, right up until the past couple of weeks of the year when the US market experienced its huge rally. He believes this year could be more of the same and that valuations in developed foreign markets remain 15% below their historical norms. Also, most analysts believe the bear market in bonds has ended and are bullish on fixed income for 2024. Forecasting the markets and economy is always hard, but this is especially so since the Covid distortions, and opinions are all over the board for this year. While the tendency of big Wall Street firms is to be bullish, that is not necessarily the case this year as evidenced by the JPMorgan forecast. On the other hand, there are well-known independent analysts (e.g., Jim Bianco) who remain generally optimistic on the economy and markets.

Whatever unfolds over the coming year, retirement plans are long-term investing vehicles, and the best approach is to have an investment plan best tailored to your personal facts and circumstances. If you are unsure about your plan, we recommend you contact us to review your portfolio.

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