December 2023 Capital Markets Commentary

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"You miss 100 percent of the shots you never take."

Wayne Gretzky

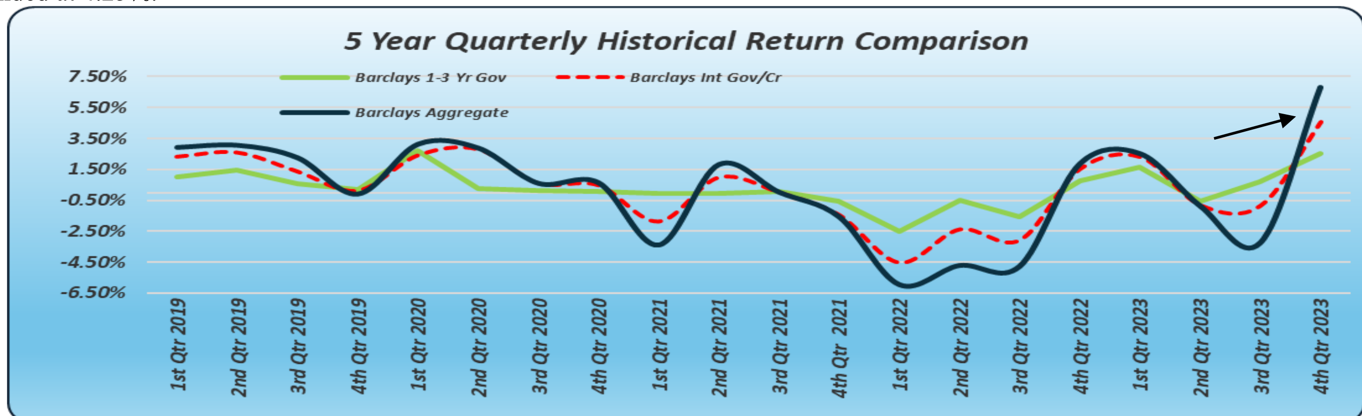
Fixed Income

The Fixed Income markets enjoyed a strong end to the quarter and to 2023. During the 4th quarter of 2023, fixed income markets experienced a strong market with the Bloomberg Aggregate Bond Index gaining 6.82% in the quarter and ending the year with a positive return of 5.53%. The downward pressure on yields, and the positive returns for the year-end / quarter-end seems to have been driven by increased optimism that the Fed has completed its current policy cycle of raising rates.

During the quarter, yields fell across the Treasury curve. The 2-Year Treasury decreased from 5.03% to 4.25% and the 10-Year fell from 4.58% to 3.88% during the quarter. Interest rates moved lower, due to a rally that was driven primarily by expectations of a dovish stance in the Fed's inflation fight. This was reinforced by the FOMC's decision to leave Fed Funds unchanged in the 4th quarter, and positive inflation news as December ended. Due to the favorable Fed Policy and inflation improvements, market participants moved strongly on yields, as seen in the 2-month drop in yields in the 10-year Treasury of near 95 basis points.

The FOMC met during the quarter, as scheduled, but as anticipated by the previous meetings, left the target Fed Funds in a range of 5.25% to 5.50%. Inflation is still higher than the Fed would like, and although content with where rates are, the Fed still stated that rates could remain higher through mid-year.

As we can see, returns were positive on all parts of the curve during the quarter. The Barclays U.S. Aggregate posted a +6.82% return for the quarter. The Barclays Intermediate Index was at +4.56%, and the short end of the curve was positive with the 1-3 Year Government Index at +2.55%. At the truly short end of the curve, even the 1 Year T-Bill returned +1.85% for the quarter. The 10-year Treasury yield ended the quarter at 3.88%. The 5-year Treasury yield ended at 3.84%, and the 2-year Treasury yield ended at 4.25%.



Fixed Income Markets - Looking Ahead

At the December meeting just like the September and November meeting, the Fed paused. (Why? There may actually be a reason.)

With the economy ending the year on a relatively strong footing and peak rates likely behind, the first quarter of 2024 appears to be the start of a new cycle for global central banks. With inflation measures trending in the right direction, the employment picture proving resilient and the economy slowing, the markets anticipate that policymakers may shift away from a period of aggressive policy action toward observation;(In English - a pause). This environment will likely lead to bond yields remaining elevated (and attractive), while the appeal of short-term cash equivalents diminishes. This will put pressure on growth assets as well as allow policymakers to attempt to sidestep a recession and eventually lead to a policy change in later 2024. So, what happens to fixed income investors? In the short term, high quality fixed income that realizes an extension in duration might be able to deliver good results on a risk-adjusted basis. For those with a longer-term investment horizon, adding risk now will likely be rewarded as policymakers shift from a hawkish stance towards a dovish stance in the year ahead.

The Fed's top priority of inflation remains. But, while progress has been achieved, the Fed's desired target of 2% remains a goal. Although the Fed has paused on new rate hikes, Fixed Income markets need to proceed with caution.

Equity

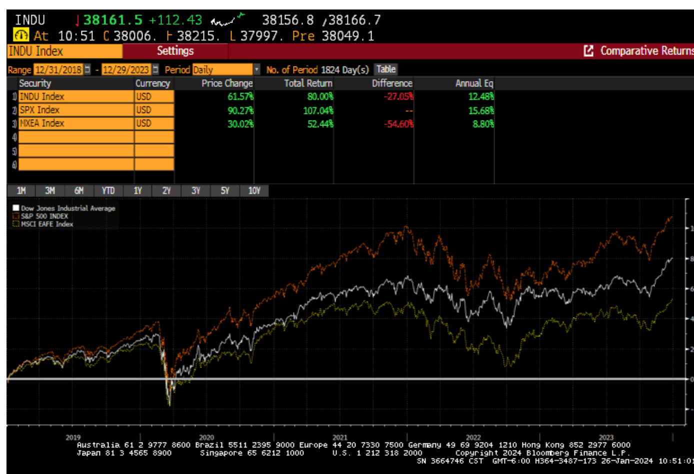
The 4th Quarter ended, and 2023 came to a close. With that, 2023 marked a much-needed comeback when it came to both stock and bond market performance after a brutal 2022.

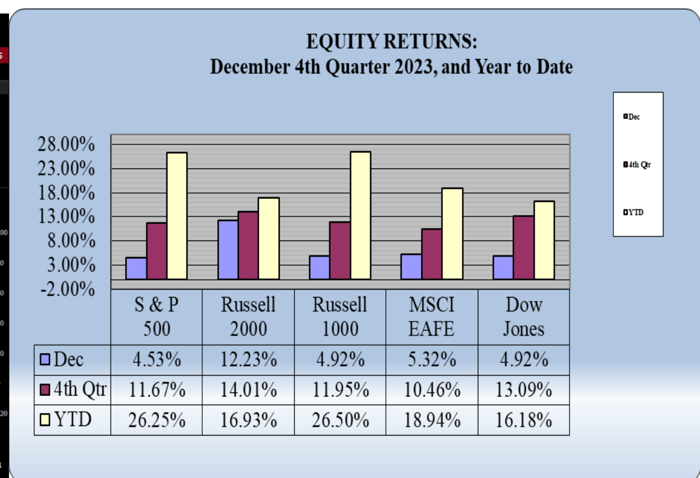
Reinforced by the combination of a solid economy, better-than-expected corporate earnings, and an apparent end to the Federal Reserve's interest rate hikes, stocks rallied 25% in 2023. Technology stocks (and growth stocks more broadly) jumped thanks to expectations of multiple Fed rate cuts in 2024, along with the emerging boom in artificial intelligence technologies.

Investors came into 2023 worried about inflation and expecting a recession by the second half of the year. Instead, inflation cooled, and the economy remained solid despite the first-quarter regional banking crisis, which sparked fears of a credit crunch. While the Fed raised interest rates four times over the year, they stopped in the 4th quarter, and the FOMC signaled that no additional increases are expected, and they will likely lower rates in 2024.

The 4th quarter began with investors worried and October being a negative month. However, this nervousness quickly dissipated, as falling global bond yields, and fears of a rebound in inflation and concerns about a future economic slowdown were abated. In summary, the markets reversed course in the 4th quarter with increases across all major indices.

Both U.S. and International equities were positive in the 4th quarter. On the U.S. side, the Russell 2000 index returned +14.95%, the Russell 1000 index returned +14.01%, the Dow returned +13.09%, and the S&P 500 ended with positive return for the quarter, showing a return of +11.67%. The International markets were in line with positive returns, posting a +10.46% for the quarter.





	S & P 500	Russell 2000	Russell 1000	MSCI EAFE	Dow Jones
Dec	4.53%	12.23%	4.92%	5.32%	4.92%
4th Qtr	11.67%	14.01%	11.95%	10.46%	13.09%
YTD	26.25%	16.93%	26.50%	18.94%	16.18%

Equity Markets - Looking Ahead

<u>2024</u> – How does 2024 play out? As we begin the 1st quarter of 2024, the outlook for stocks is still positive.

In 2022, the S&P 500 slid close to -20% in the wake of the Fed's decision to rapidly hike interest rates. However, equity markets advanced in 2023, recovering some or all the lost ground from 2022.

While stocks were positive to close out the year, the outlook for earnings growth was not been as strong as investors hoped. Equity concentration in the S&P 500 during 2023 was at levels not seen since the 1970s, meaning the rise in stocks in 2023 was driven by a cluster of tech mega-cap stocks. This dynamic, which has been seen ahead of prior economic slowdowns — along with an end to a period of high pricing power as 40-year high inflation begins to soften — indicates that corporate margins might face major headwinds in 2024.

Heading into 2024, inflation seems to be trending steadily lower. However, many analysts and economists are concerned the last part of the Federal Reserve's battle with inflation will be more difficult than expected, and a U.S. recession could still be looming. And while the stock market rallied to end the year, the New York Fed's recession probability model estimates there is still a 51.8% chance of a U.S. recession within the next 12 months.

Historically, both the stock and bond markets performed well in the months after the last rate hike. If we have in fact seen the last rate hike in this cycle, that could push markets higher as 2024 progresses. But don't forget we are in an election year. U.S. <u>presidential election years</u> have historically produced lackluster stock market gains for investors.(Food for thought)

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The Economy

The Economy

As expected, the Federal Reserve left interest rates unchanged at its December meeting. Given that the decision was largely a foregone conclusion, investors were more interested in the Fed's revised "dot plot" projections showing policy makers' updated forecasts for the Fed Funds rate in 2024. With that, investors were excited to find that the Fed now expects to cut rates by a total of 0.75% in 2024, up from the prior forecast of 0.25%. Investors treated the Fed's updated forecast as a "floor" on the number of possible rate cuts in 2024, with current market expectations anticipating a total of between four(4) and six (6) 0.25% rate cuts, lowering the Fed Funds rate to around 4.00% to 4.50% by the end of 2024.

Throughout the current rate hike cycle, the Fed has stressed the lagging, cumulative impacts stemming from higher rates. Many economists at the start of 2023 expected those impacts to quickly result in slower economic activity, reduced hiring, and higher unemployment. While all three of those occurred, they did not reach the level that was expected. One of the major keys to economic resilience in 2023 was the continued strength of the consumer which progressively surprised to the upside. As measured within GDP, consumer spending increased on average by 2.6% in each of the first three quarters of 2023, compared to full-year growth of 2.5% in 2022 and 2.0% and 2.7% in 2019 and 2018, respectively.

The Federal Funds Rate is now in the 5.25-5.5% range, 225 basis points higher than one year ago, and as mentioned last quarter, futures markets are expecting that this is likely as high as we will get in this cycle. Of course, these expectations could change quickly as new economic data comes in. Continued inflation, (albeit lower than before), could require more hikes, but a recession could require cuts.

The Economy - Looking Ahead

Economic Growth? Jobs? Inflation? Recession? Global problems? The same old tune.

The downward trend in inflation has bolstered market confidence that monetary policy is now sufficiently restrictive as to achieve the FOMC's longer run goals. One indicator of this was the October CPI print, which marked the first time this policy cycle that market pricing discounted no additional rate hikes. Furthermore, FOMC policy rhetoric turned more dovish as 2023 closed, suggesting that a possible critical inflection point has been reached in fixed income markets.

Historically, the final rate increase of a hiking cycle has been a reliable guidepost for interest rates in which duration switches cyclically from being a headwind to a tailwind for bonds. Indications suggest that there will be no change this time either, as an appetite for duration extension has returned and investors that had been looking further clarity on the path of Fed policy are now returning to the market, leading to the pronounced rally in interest rates as the year ended.

Going into the new year, unemployment claims will be a key metric to follow in the U.S. Hiring has slowed steadily since the Fed began its rate hiking campaign, and the labor market is showing many signs of achieving better balance after a period of extreme post-pandemic tightness. Aggregate weekly hours, overtime hours, and temporary hiring have all declined significantly, but layoffs and unemployment claims have remained low. This environment indicates that companies that once faced challenges attracting employees are now hesitant to reduce headcount, especially as the consumer has remained resilient. At this stage, companies have cut work but not workers. Any sustained increase in unemployment claims would signal an escalating slowdown and an imminent recession.

Heading into 2024, inflation seems to be trending steadily lower. However, many analysts and economists are concerned the last part of the Federal Reserve's battle with inflation will be more difficult than expected, and a U.S. recession could still be looming. And while the stock market rallied to end the year, the New York Fed's recession probability model estimates there is still a 51.8% chance of a U.S. recession within the next 12 months.

It appears this Fed rate hike cycle is over and now we will pivot to potential rate cuts. But not until inflation has sufficiently cooled. As we've seen before, a lot can happen in the meantime.

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