STRATOS
INVESTMENT MANAGEMENT

PIVOT: 2023 YEAR-END COMMENTARY & 2024 OUTLOOK

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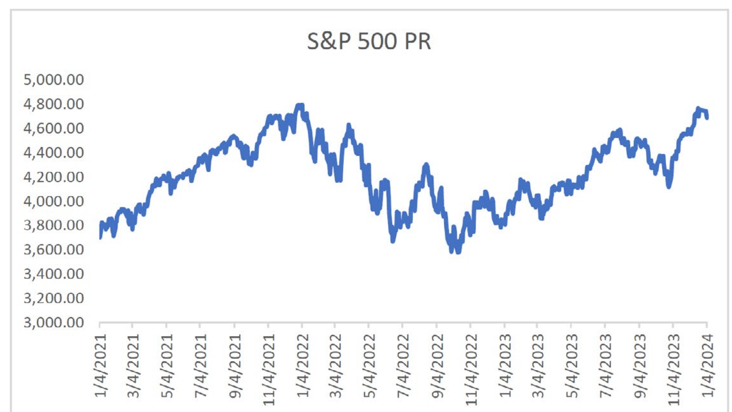
In some ways 2023 reminded us of an old SNL character, Emily Littela, who would go on rants only to be interrupted and told that she misunderstood the topic. She always replied, “never mind.”

Markets started the year in a fairly good mood only to be sent into panic mode with the insolvency of three mid-sized banks. Certain that the closures of Silicon Valley Bank and Signature Bank were the harbinger of another financial crisis, equity markets sank from early February to mid-March. Yet, once the Fed stepped in and provided liquidity and quickly found buyers for the assets, even the closure of First Republic in May of the year was not enough to stall the renewed march higher. It was as if the markets had decided, like the fictitious Emily Littela, “never mind.”



Source: Morningstar Direct

Equities were led by the "Magnificent Seven" (Mag-7) which meant that, given the market capitalization weighting of most broadly used benchmarks, if you didn't own them, you under performed. (The "Magnificent Seven" include: Apple (NASDAQ:AAPL); Microsoft (NASDAQ:MSFT); Alphabet (NASDAQ:GOOGL); Amazon (NASDAQ:AMZN); Nvidia (NASDAQ:NVDA); Meta Platforms (NASDAQ:META) and Tesla (NASDAQ:TSLA).) These seven names represented 30% of the market capitalization of the S&P 500 as of year-end and had an average return of 111.27%. Even if you removed the top three performing names of the Mag-7 (Nvidia – up 239%, Meta – up 194% and Tesla – up 102%) the average performance of the remaining was more than twice that of the S&P 500's return.

Domestic Large-Cap equities led the performance derby for the year with the S&P 500 rising 26.29%. The more broadly diversified Russell 3000 wasn't too far behind, climbing 25.96% and in third place was international stocks as described by the MSCI All-Cap World Index which increased 21.58%. Domestic smaller-cap stocks depicted by the Russell Mid-Cap and Russell 2000 brought up the rear with still respectable double-digit returns of 15.99% and 16.93% respectively. This simply reinforces our earlier statement that the Mag-7 drove performance as they were and are absent from the smaller-cap indices.

Source: Macrotrends

Bond markets bought into the idea of higher for longer and decided, after the bank insolvency scare, that economic growth and inflation would likely be stronger than expectations as the 10-year touched 5% in early Q4, up from a low for the year of 3.35%. Yet, inflation began to moderate towards the Fed's target and bonds, which looked like they would see another starkly negative year, also decided things weren't quite so bad.

Bond returns ended the year nicely positive with generally coupon-plus returns. Performance was led by the Bloomberg Aggregate which climbed 5.53% followed by the FTSE World Global Bond Index rising 5.26%, the Bloomberg US 1-5 Yr Gov't/ Credit which was up 4.89%, the ICE Bank of America 1 Yr Treasury Index increasing 4.74% and the ICE Bank of America 1-3 Yr Treasury Index increasing 4.26%.

Fed Chair Powell tried to be Santa Claus on December 13th when he omitted the words, "bringing down inflation would likely require weaker growth and hiring," used at the beginning of every statement since July 22. This, of course, got the market's hopes up for rate cuts beginning as soon as March of this year with as many as five additional rate cuts coming in quick succession after the March adjustment.

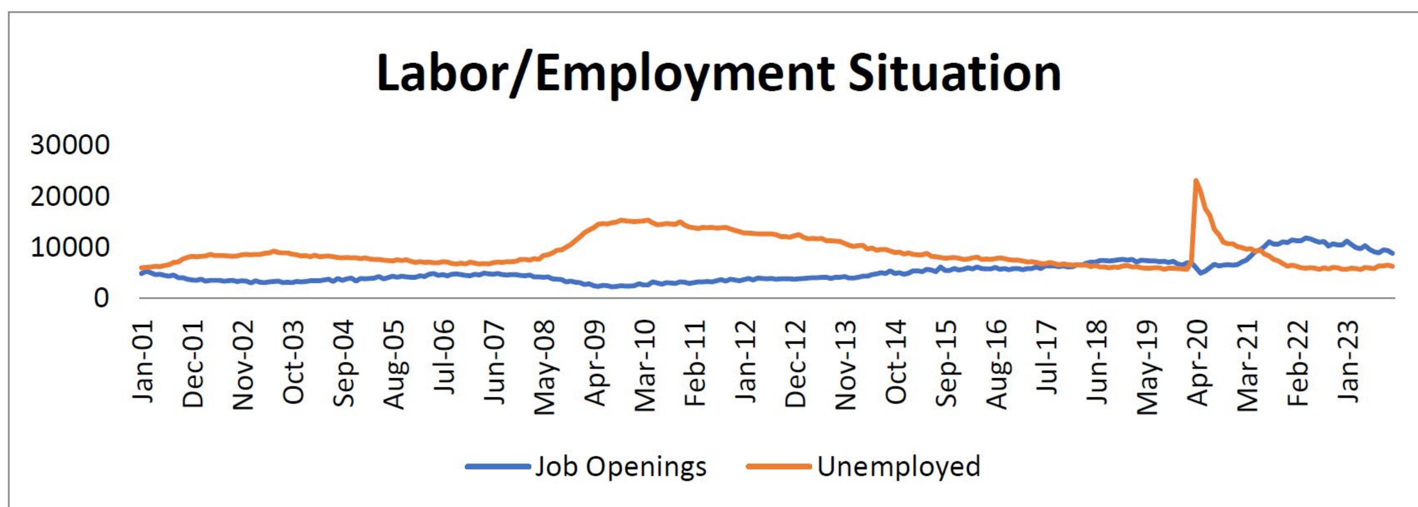
Our response has been, "oh, really? What happened to the soft landing?" Has the Fed really pivoted from higher for longer to lower faster? We don't think so. For whatever reason, Chair Powell has often found a need to back-pedal on comments made as the market often reads things into them that aren't really there. Will the Fed Pivot? Yes. Will they bring rates down as quickly as the market has anticipated (six cuts in 2024)? We don't believe so.

Six rate cuts would imply that the economy is on the brink of a downward spiral that we simply don't believe, barring any unforeseen

events, will happen. Quite frankly, we have believed that the economy has been experiencing rolling recessions that may well continue but won't be enough to push the US economy into a full-blown recession. Why? In a word, jobs.

We realize that employment/ unemployment is a lagging indicator, but the reality of the situation is that we still have more jobs available than people to fill them.

We have been following JOLTS (Job Openings and Labor Turnover Series, US Bureau of Labor Statistics) for some time and the spread between job openings and unemployed persons, while narrowing, is still wider than at any point prior to the COVID recession (see chart below). In our view, as long as there are more jobs than people to fill them, consumers will continue to spend. This will likely also mean that wage inflation will continue apace. Demographically, there simply aren't enough new people entering the labor pool to offset the Boomers leaving.



Source: St. Louis Fed

Continued war in Ukraine, the potential for a wider conflict in the middle east and concerns over Chinese saber rattling will likely mean higher global defense budgets and continued supply chain issues in manufacturing. This will also likely add fuel to the (ebbing) inflation fire.

Fortunately, there are also things that could allay inflationary concerns. While money supply growth certainly didn't help the inflationary environment, much of the post-COVID inflation was simply the logical snap-back as demand for "stuff" outstripped supply, with supply being further hampered by geopolitical events. As the supply demand relationship normalizes the inflationary pressures should continue to subside.

Additionally, an aging economy is deflationary. While the demographic make-up of the United States is better than much of the developed world, the fact remains that the average age of the US continues to climb with the fastest growing age demographic being 65-plus.

As outlined above, we don't believe that the Fed will cut rates six times this year. While we do believe that they will likely begin reversing course on rates, it likely won't happen until perhaps the second half of the year with only a couple of quarter-point cuts. The Fed is and will remain "data dependent".

Assuming the Fed begins a down-cycle on rates, the cycle will not need to be as aggressive as the past with the end point well above zero. This will likely mean that, while bond yields could also move lower, the bond market response may also likely be muted, resulting in coupon or modestly coupon-plus returns.

Giving us pause is the nearly universal belief that now is the time to go all in on longer-term (market neutral duration), high quality bonds. In our experience, when everyone is arriving at the same conclusion, it's usually wrong. The yield curve is still inverted (short rates higher than long rates) and if the curve normalizes that could well put pressure on bond returns.

While market multiples will likely contract, in our mind this will reflect more of a market broadening rather than a decline in overall prices. Equities, we believe could have a decent year in 2024. While the Mag-7 had their year in the sun, we believe that the market could broaden out with small(er) companies having better performance, resulting in markets ending the year with more muted, but positive returns in the 8-10% range.

What might throw cold water on our expectations? Surprises. We are entering political silly season with the Presidential race in full swing as the Iowa caucuses will already be completed once this goes to press. Geopolitics could throw us a knuckle ball as Russia, China, North Korea, Iran or an unforeseen actor broadens global conflict. We could also have some kind of economic or business dislocation that isn't even on the radar screen. Will an unexpected insolvency create panic? Most assuredly, but perhaps not this year.

The most likely pathway for the year is likely to be rather benign. Steadily, but not dramatically, higher returns form equities, bonds that provide couponish returns and an economy that continues to march steadily forward with moderating inflation. Goldilocks? Not really, but not bad either.

Sources: Morningstar, US Bureau of Labor Statistics JOLTS database, Federal Reserve Bank of St Louis FRED database, Macrotrends.com, “Magnificent Seven Stocks Had A Juge 2023. All Are In Prime Position Heading Into 2024,” by Ed Carson, IBD.com, January 2, 2024

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