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Market Newsletter
Fourth Quarter 2023

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EXECUTIVE SUMMARY

- Hopes of a ‘soft landing’ and interest rate cuts by the Federal reserve propelled stocks and bonds in the fourth quarter of 2023 leading to good annual performance.

- The unique post-pandemic economic cycle has been filled with conflicting economic data leading to what some have dubbed ‘rolling recessions. Some areas have undergone recessionary weakness while others are relatively strong.

- Inflation has decisively and significantly subsided from the highs set in 2022.

- The Federal Reserve acknowledged some progress in curbing inflation through tighter monetary policy but emphasized the need for continued vigilance.

- In 2023, corporate earnings exhibited slow and uneven growth, reflecting the economic uncertainty.

- Investing in themes seems good on paper but not practical, you are better off investing in a diversified portfolio of large well-established companies.

- ‘It is about time in the markets and not timing the markets’. Missing 14 of the best days last year would have reduced your performance to 0% vs over 26% if you had stayed invested all through the year.

Table 1: Market indices

(*Returns include dividends reinvested*)	**Quarter to date**	**Year to date**	**1 Year**	**3 Year Annualized**	**5 Year Annualized**
S&P 500	11.69%	26.29%	26.29%	10.00%	15.69%
S&P Mid Cap 400	11.67%	16.44%	16.44%	8.09%	12.62%
S&P Small Cap 600	15.12%	16.02%	16.02%	7.28%	11.03%
MSCI Emerging Markets	7.93%	10.27%	10.27%	-4.71%	4.08%
MSCI EAFE	10.47%	18.85%	18.85%	4.53%	8.69%
Vanguard Total Bond Market Index	6.68%	5.58%	5.58%	-3.47%	1.01%
Investment Grade Credit	7.93%	8.40%	8.40%	-3.17%	2.63%
Non-Investment Grade Credit	7.06%	13.46%	13.46%	2.00%	5.21%
Bloomberg Commodity Index	-4.71%	-8.00%	-8.00%	10.73%	7.21%
Dollar Index	-4.56%	-2.11%	-2.11%	4.06%	1.05%
10 Yr. Rate	3.87% 12/31/2023	3.87% 12/31/2022	3.88% 12/31/2022	0.92% 12/31/2020	2.69% 12/31/2018

Source: S&P Dow Jones, ml.com, MSCI.com, Morningstar, Bloomberg, Yahoo Finance

Table 2: Recent Major US Economic Releases (These indicators have a significant impact on the stock market)

As of 01/05/2024			
	Latest Release	Recent Trend	Notes
Non-Farm Employment	216,000	Positive	Non-farm payroll was better than expected tempering expectation of a slowing economy and interest rate cuts. Unemployment rate was 3.7%. Average hourly earnings rose by a larger-than-expected 0.4%. However, numbers for the previous two months were revise downwards.
Weekly Claims for Unemployment Insurance	202,000	Positive	Claims for unemployment was lower than expected and is hovering around its recent lows.
ISM Manufacturing Index (over 50 indicates growth)	47.4	Negative	Manufacturing activity seems to have stabilized and improved in December. However, with the index below 50, manufacturing activity is still contracting.
ISM Non Manufacturing Index (Over 50 indicates growth)	50.6	Negative	US services sector growth fell to the lowest level of the year. The employment situation in the services sector fell to the lowest level in three years.
Consumer Prices (Month over month change)	0.1%	Positive	Headline inflation continues to drop as overall prices have dropped by 3.1% from a year ago. Core inflation which strips out food and energy continues to be sticky having increased by 4% from a year ago.

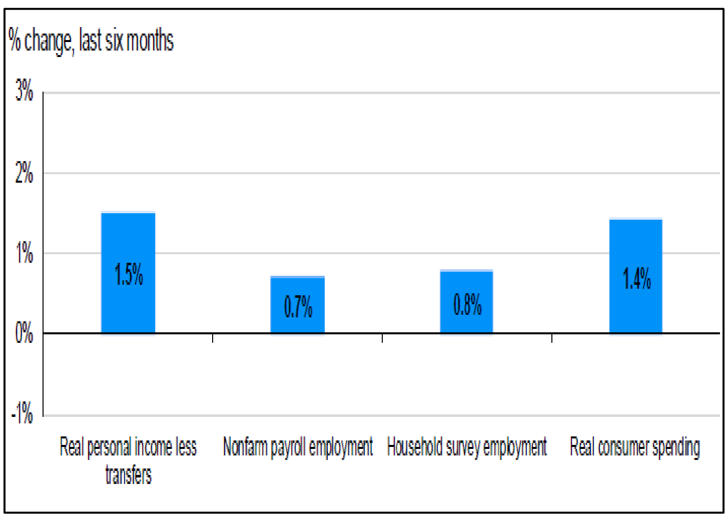
	Latest Release	Recent Trend	Notes
Producer Prices (Month over month change)	0	Positive	Falling energy prices helped to bring wholesale inflation below pre-pandemic levels and to its second-lowest rate this year. Producer prices have increased by 0.9% since last year.
Retail Sales (Month over month change)	0.3%	Positive	Helped by a strong jobs market, retail sales surprised to the upside. A holiday sales report by Mastercard reinforced the view that consumers are continuing to spend.
Consumer Confidence (Conference Board)	110.7	Negative	After falling since 2022 because of high inflation, consumer confidence has been stabilizing. The most recent data point reflects a positive view on business conditions, jobs available and less pessimistic views of business, labor market and personal income prospects.
Durable Goods Orders (Month over month change)	5.4%	Positive	Durable goods order soared in November helped by aircraft orders. Non-defense capital goods orders excluding aircraft (Called core capital goods order) increased 0.8% after a downwardly revised 0.6% drop in the prior month.
Industrial Production (Month over month change)	0.2%	Positive	Industrial production rose more than expected in November helped by auto and auto parts production that resumed after an end to the auto workers strike.
Capacity Utilization	78.8%	Positive	Capacity utilization improved in November but is still marginally lower than its long term average.
Housing Starts	1.56 Million	Positive	Single family housing starts increased by 14.8% in November to a one and a half year high. A decline in mortgage rates from record high levels and builder's incentives helped.
Home Prices (Case-Shiller Home Price Index- Year over Year)	0.3%	Positive	Home prices rose in October at the fastest rate of the year. Prices are up from last year at 4.8% nationally and 4.9% in the 20 largest cities.
GDP (Real, Annualized)	4.9%	Positive	Third quarter US GDP was weaker than the last estimate but was still much stronger than expected at the beginning of the quarter.

Source: Bloomberg, www.federalreserve.gov, www.bls.gov, www.ismword.org, www.nahb.org

Global stock and bonds rose sharply in the fourth quarter of 2023 to end the year with strong annual performance numbers. Towards the end of the year, previous laggards such as stocks of smaller companies and those of foreign companies rose furiously as the market rally broadened out. Even Emerging Market stocks joined the rally despite being held back by Chinese stocks which continued their slump. Falling interest rates helped bonds of all kinds rally in the fourth quarter and log in strong performance for the year. The only asset classes that fell during the period were Commodities and the US dollar, both of which reversed their 2022 positive performance. The underlying reasons that fueled the market performance were falling inflation, hopes of a soft landing of the economy (i.e no imminent recession) and the hope that the Federal Reserve (The Fed) would cut interest rates sooner than previously expected.

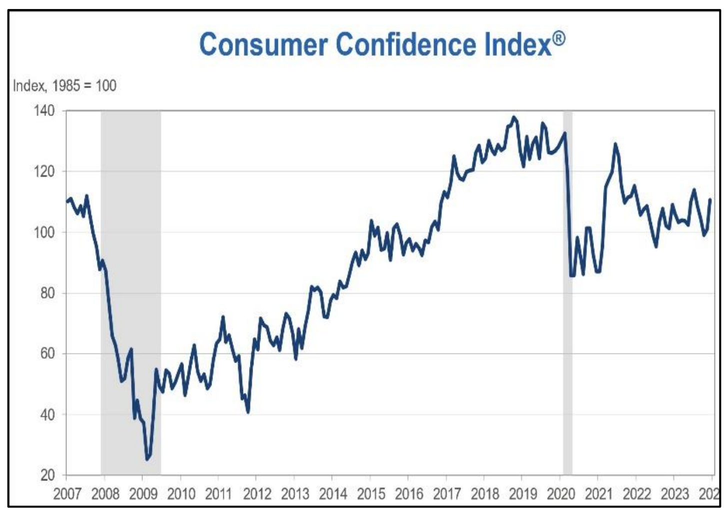
2023 was a year that defied expectations in many ways. Most forecasts at the beginning of the year predicted that the US economy would enter a recession as the Federal Reserve raised interest rates to fight high inflation. But the economy remained resilient, inflation eased, and the Fed stopped lifting rates towards the end of the year. Digging deeper under the surface, the US economy saw a mixed bag of economic data supporting both the optimists, who don't think a recession is imminent and the pessimists, who expect the US economy to 'hard land' with a recession. While consumer confidence has stabilized and consumers are continuing to spend, supported by a strong jobs market, and falling inflation, (Fig 1 and 2) businesses are being cautious as evidenced by moderate corporate investments and a slowdown in the manufacturing and the services sector. (Fig 3 and 4). The Conference Board index of leading economic indicators (Which is a harbinger of future economic health) has dropped significantly since 2021 but has been stabilizing lately (Fig 6). The unique post-pandemic economic cycle has been filled with conflicting economic data leading to what some have dubbed 'rolling recessions'. Some areas of the economy such as housing, manufacturing, consumer confidence and sentiment have undergone recession level weakness (Fig 5) but have been supported by other areas such as the services sector and employment which are relatively healthy.

Fig 1: Consumer jobs, income and spending



Source: JP Morgan

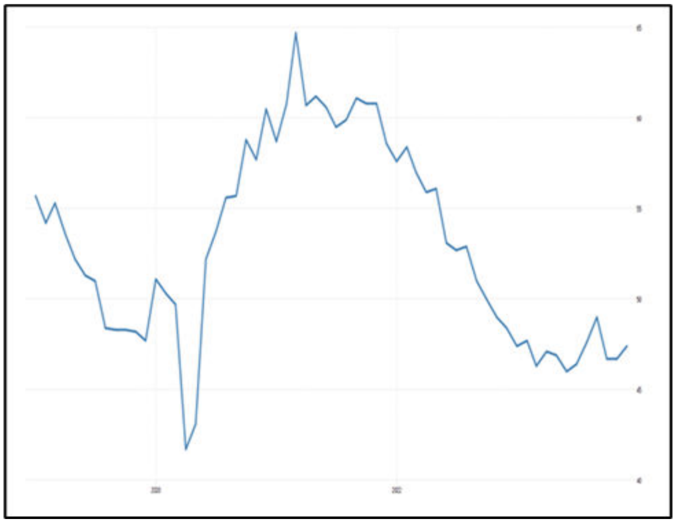
Fig 2: Consumer confidence has stabilized.



Source: JP Morgan

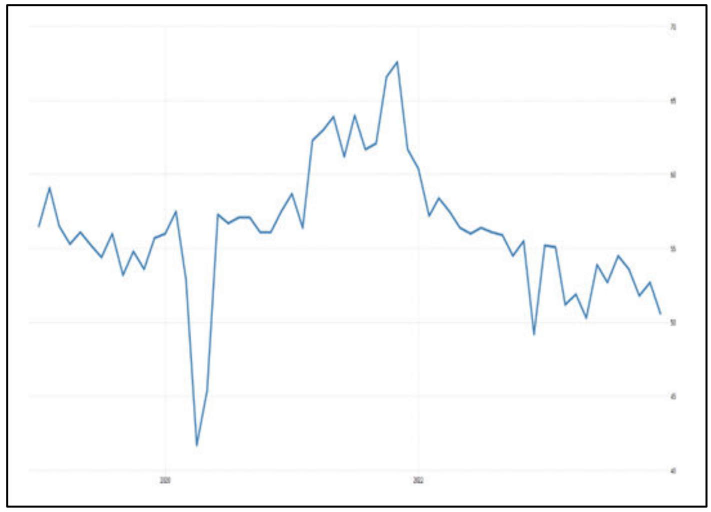
Amidst the crosscurrents of economic data, inflation has decisively and significantly subsided (Fig 7). The annual inflation rate for the 12 months ending in November was 3.1% (Down from a peak of 9.1% in 2022) and forward-looking indicators such as the 5-year /5-year forward rate are showing that inflation will settle in at just above 2% (Fig 8), a level that would pacify the Fed. In its latest meeting, the Fed maintained the target range for the federal funds rate at 5.25% to 5.50% while reiterating the commitment to bringing inflation down further. It acknowledged some progress in curbing inflation through tighter monetary policy but emphasized the need for continued vigilance. In his press conference, the Fed Chairman Jerome Powell emphasized the data-dependent nature of future policy decisions and reiterated the Fed's flexibility to adjust if the economic situation evolves differently.

Fig 3: The Manufacturing sector is contracting



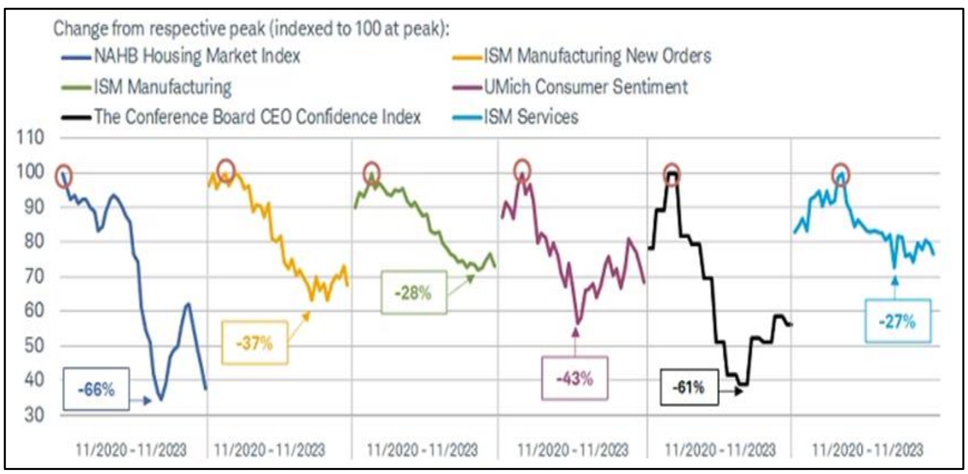
Source: St Louis Federal Reserve

Fig 4. The services sector is (barely) growing (Index > 50)



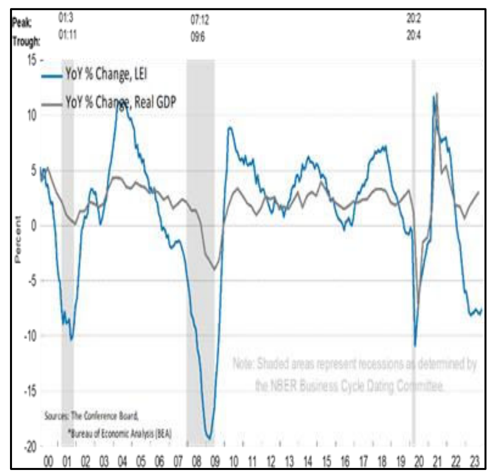
Source: St Louis Federal Reserve

Fig 5: Some areas of the economy are at recessionary levels



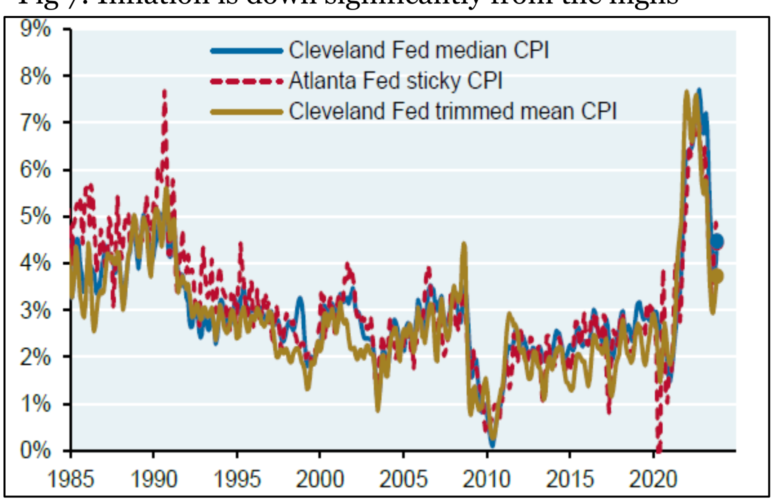
Source: Charles Schwab

Fig 6: Leading Economic Indicator



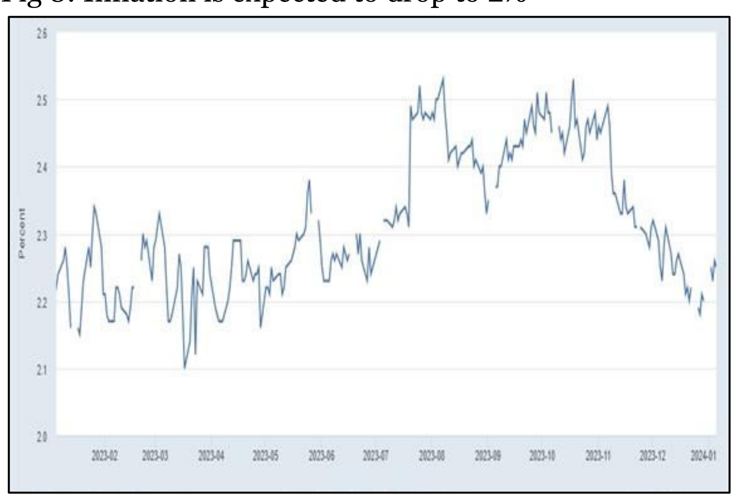
Source: The Conference Board

Fig 7: Inflation is down significantly from the highs



Source: JP Morgan

Fig 8: Inflation is expected to drop to 2%



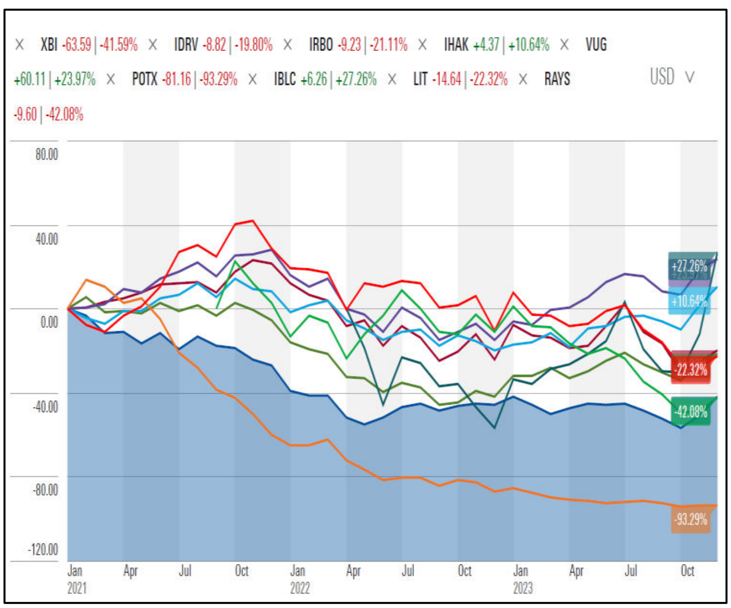
Source: The St. Louis Federal Reserve

In 2023, corporate earnings exhibited slow and uneven growth, reflecting economic uncertainty. According to Factset, companies in the S&P 500 index could report an earnings growth of 0.6% for the entire year. While this is significantly below the 10-year average growth of 8.4%, the trajectory of quarterly earnings growth was positive in 2023. The year started with two quarters of declines (-1.7% in Q1 and -4.1% in Q2) but saw a rebound in Q3 (4.9% growth) and is projected to finish with modest growth in Q4 (2.4%).

Thematic investments sound good on paper

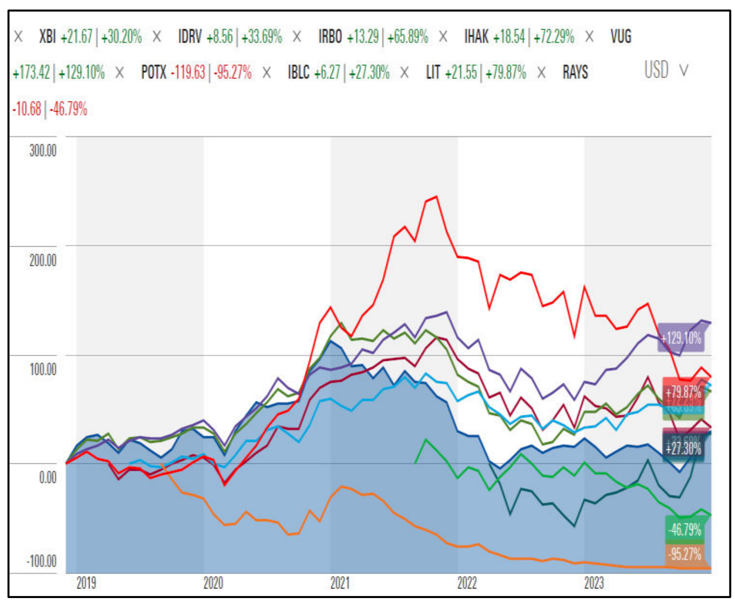
Continuing our previous discussions on the benefits of investing in a diversified portfolio (See 3Q 2023 Newsletter) and the perils and pitfalls of investing in profits less innovation (See Q4 2022 Newsletter), another investment concept, the idea of investing in themes, seems good on paper but does not translate well into practice. Figs 9, 10 and 11 show the recent performance of some themes that captured the imagination of investors recently. Many of these thematic investments have performed very poorly since the beginning of 2021. Looking at their performance over a longer time you can see some of themes such as Cannabis and Solar power have crashed while other such as Internet Security and Driverless cars have done relatively better. However, even the themes that had positive performance over a longer 5-year period could not match the performance of a diversified portfolio of large growth companies represented by the Vanguard Growth Index Fund ETF (VUG). The conclusion is that picking themes that will turn out to be profitable is difficult and you are better off investing in a diversified portfolio of large well-established companies.

Fig 9: 3-year performance of themes



Source: Morningstar

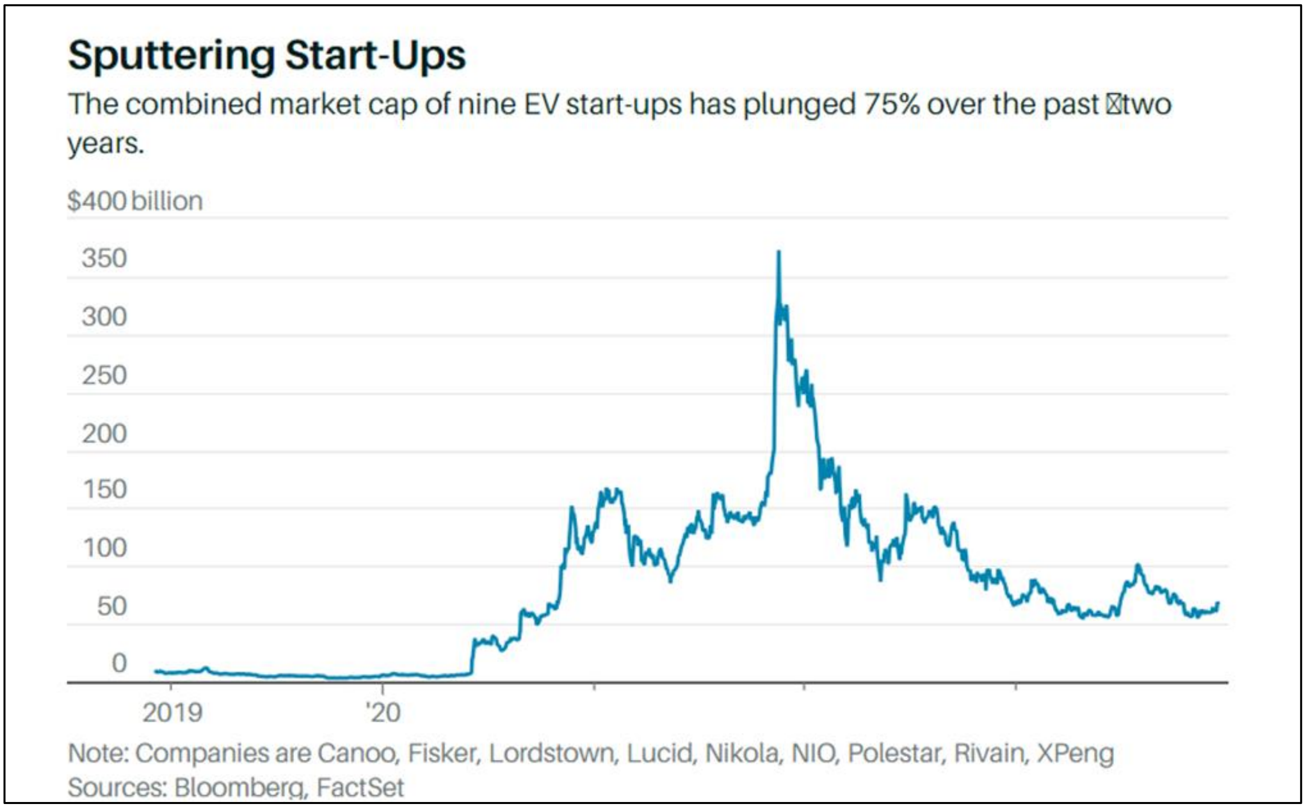
Fig 10: 5-year performance of themes



Source: Morningstar

Key: XBI: SPDR S&P Biotech ETF, **IDRV**: iShares Self-Driving EV and Tech ETF, **IRBO**: iShares Robotics and Artificial Intel ETF, **IHAK:** iShares Cybersecurity and Tech ETF, **VUG**: Vanguard Growth Index Fund ETF, **POTX:** Global X Cannabis ETF, **IBLC:** iShares Blockchain and Tech ETF, **LIT:** Global X Lithium & Battery Tech ETF, **RAYS:** Global X Solar ETF

Fig 11: The combined market value of nine EV companies has plunged 75% over the last two years.



Source: Bloomberg

<u>2023 validated the wisdom of staying in the markets.</u>

You have heard us say this before: 'It is about time in the markets and not timing the markets'. The surprise positive performance of stocks in 2023 supports this wisdom. If you sold stocks after the poor performance in 2022, spooked by uncertainty and predictions for further pain, you lost out on the eventual rebound in stocks. Furthermore, if you had missed the best 14 days out of a total of 249 trading days in the year, your performance represented by the S&P 500 would have been flat vs over 26% if you had stayed in the market for the entire year! Even missing just 5 of the best days of the year would have cut your performance by half.

Fig 12. Performance of the S&P 500 index with dividends reinvested.

Best Days Missed	Performance
0 days	26.90%
5 days	14.90%
10 days	5.70%
14 days	-0.20%

Source: Yahoo Finance, Sarsi