Economic Overview

Steve Scranton, CFA, SVP, Chief Investment Officer and Economist

Economic growth in the 4th quarter remained resilient and positive. Although the first estimate of 4th quarter economic growth (GDP) will not be released until the end of January, all signs point to slower growth than the 3rd quarter but still positive. The range of forecasts is currently between 0.5% to 2.5% annualized growth.

Looking at 3rd quarter economic growth as a possible guide to 4th quarter growth shows that, on the surface, it appears consumers fell back in their contribution to 3rd quarter economic growth while business spending gained ground.

- Consumer spending accounted for 43% of 3rd quarter economic growth.
  That is far lower than the historical contribution which is closer to 60%.
- Business spending contributed 36%.
- Net exports contributed 1%.
- Government spending contributed 20%.

Upon closer inspection, business spending was driven heavily by an increase in inventories. Inventory spending is a volatile contributor depending on whether businesses successfully forecast future growth. If businesses increase inventory too much, then the next quarter may see inventory spending subtract from economic growth as businesses cut back on inventory spending to reduce their stockpile. The opposite is true if businesses did not buy enough inventory. With the holiday season occurring in the 4th quarter, the question is: did businesses build inventory in the 3rd quarter in anticipation of strong 4th quarter spending by the consumer? What we have seen from the 4th quarter data that has been released is that both wholesale and retail inventories have fallen, indicating that businesses are drawing down the inventory built from the 3rd quarter which would indicate that inventory spending was a drag on economic growth in the 4th quarter.

Consumers showed resilience throughout 2023 and it appears that they continued their spending patterns in the 4th quarter as well. We have to view the reports of record sales during Black Friday and Cyber Monday cautiously because those sales are reported in dollars not units. Even though the growth rate of inflation slowed dramatically in 2023 compared to 2022, prices still rose. As a result, the record dollar sales may simply mean that consumers were paying more for the same quantity of items that they purchased last year. That may help to explain why the manufacturing data shows manufacturing activity shrinking while record holiday sales are reported.

One thing that cannot be disputed is that consumers surprised the vast majority of economists (including me) by showing far more willingness to spend throughout 2023. The average forecast at the beginning of 2023 was for a recession to begin by the end of the year. That clearly did not happen as consumers benefited from historically high wage increases as well as the ability to use savings and take on debt to continue their spending. The best way to describe 2023 may be to call it the "Year of the Unexpected".

The debate now rages as to what 2024 holds. Will it be a "soft landing" that sees economic growth continue to grow in the 1% to 2% range? Will it be a "hard landing" that sees economic growth below 1% but above negative growth or will it be a recession with negative economic growth. Given the fact that 2024 is also an election year it may well be the "Year of Uncertainty".

Fourth Quarter 2023 – Wealth Management Insights

Strategy Review

Derrick Wilson, CIMA®, VP, Portfolio Manager

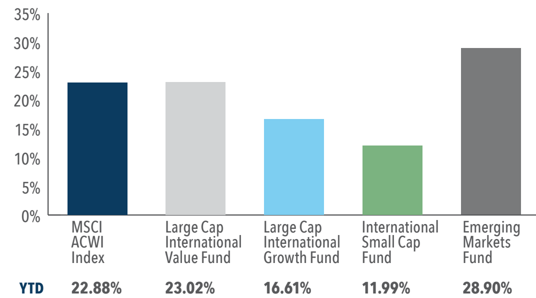
Financial markets ended the final months of 2023 on a strong note, adding to the overall gains for the year. Much of the 4th quarter market action revolved around monetary policy and central bank actions (words, really). Market expectations gradually, but consistently, brought forward rate cuts in the US and Europe during the quarter. Declines in bond yields gave rise to both stock and bond prices.

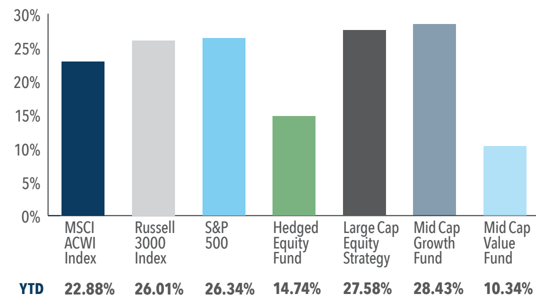
Equity markets turned higher in November and didn't stop until year-end. Major central banks continued to hold/pause interest rates, and this encouraged markets to a risk-on rally. Global equities gained just over 11% in the 4th quarter and double that over the full year. Small caps trailed for the year but led the way during the quarter's rally. Domestic equities outperformed international, and emerging markets lagged once again. China continued to weigh on EM performance with its struggling economy despite the government attempts to stimulate activity.

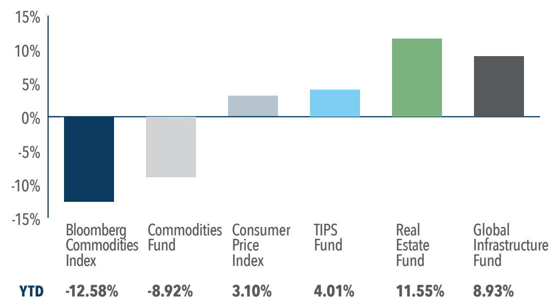
Fixed Income markets experienced a rather volatile year but rallied in the last two months as softer comments from Fed Chairman Powell, along with increased rate cut expectations from the committee, led market yields lower. Europe has seen similar effects on yields as inflation has been slowed along with a pause in interest rates, but central bank officials from both the European Central Bank (ECB) and the Bank of England (BOE) still communicated a tougher stance on the path forward with holding rates longer. Interestingly, over in Japan and opposite of rate cuts, there is the potential to move away from negative interest rates and see interest rates increase.

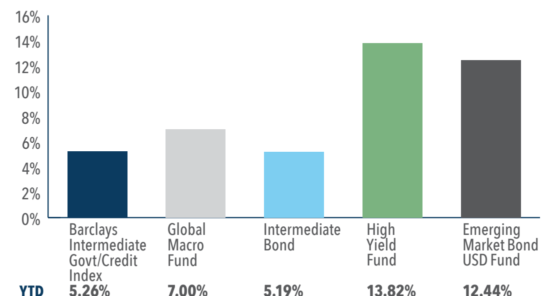
Real estate saw a nice rebound in the quarter, outperforming equities, and turning performance positive for the year. Broad commodities declined but was mixed within. Gold prices rose over 11% while WTI oil fell over 17%. Managed futures trend-following also struggled with the swift changes in direction across markets.

While not yet in the clear, indications of a soft landing could be a possibility, as the Fed has slowed inflation, but we have yet to see further deterioration in the economy, particularly in the jobs market. Of course, only through time and with hindsight will we know if they truly achieved such a feat. Heading into the unknown, a more balanced portfolio should provide protection against an economic decline, yet still participate in rising markets.









Domestic Equities

Gayle Sprute, VP, Senior Portfolio Manager

The final quarter of 2023 started on a downbeat note. The "risk off" sentiment that took shape in late July continued well into late October and produced corrections for the S&P 500, the Nasdaq Composite, and the Russell 2000. It also brought about corrections in the technology, consumer discretionary, utilities, and real estate sectors — and all of the Magnificent Seven stocks (Alphabet, Amazon.com, Apple, Meta Platforms, Microsoft, NVIDIA, and Tesla). The equity market's grudging acceptance of the Federal Reserve's (Fed) "higher for longer" interest rate message and rising concern about a possible recession brought a painful giveback from the impressive gains in the first half of the year.

But the 4th quarter had another reversal in store. Investor psychology shifted sharply back into "risk on" mode toward the end of October. An upbeat 3rd quarter GDP reading of 4.9% and cooler than expected inflation data fueled speculation that the Fed might be able to wind down its interest rate increase campaign. Fed communication added to the excitement. During the final two months of the year, although not explicitly saying rates have peaked, the Fed's messaging turned much more dovish and suggested that rate cuts are being considered.

The idea that inflation might be decelerating more quickly than expected rekindled economic soft-landing hopes, along with speculation of a path for rate cuts in 2024 — and that the Fed is done with rate increases. Since then, incoming economic data has not been able to dissuade that notion for equity investors. Inflation has continued to moderate toward the Fed's target and employment data suggests that, although labor metrics are easing, the employment market is sturdy enough to support economic growth.

All in all, investor enthusiasm fueled a breathtaking rally between October 27th and December 31st which contributed to a spectacular year of gains for the domestic indices: Dow Jones Industrial Average +16.2%, S&P 500 +26.3%, Nasdaq Composite +44.6%, and Russell 2000 +16.9%.

As we enter 2024, psychology is decidedly upbeat and optimism is elevated. At a price/earnings (P/E) multiple of 19.3X forward 12-month earnings (versus the 10-year average of 17.6X), the market is currently "priced to perfection." There is little room for disappointment in the areas of earnings, disinflation, Fed policy, and the economy.

Fixed Income

Callen Young, VP, Portfolio Manager

Rate cuts: to be or not to be, that is the question. As we end the 4th quarter — and 2023 — US Treasury yields ended right back where we started the year.

Continued hawkish rhetoric and a heavy Treasury financing calendar spurred yields to their 2023 peaks in mid-October, with nearly every benchmark Treasury security reaching a 5% yield or greater. In addition, short-term tax-free municipal bond yields rose to their 2023 peaks around the same time, with 5-year AA-rated municipal index yields reaching 3.80% just before Halloween. These levels did not stay around long, however, as early November brought a report that the US economy added surprisingly fewer jobs in October than were expected. The Fed also met in early November and declined to raise rates for the 2nd consecutive meeting while issuing some less-harsh language, noting "moderation" in the economy.

The change in tone by the Fed was met by a change in sentiment from the bond market as the focus quickly shifted from "higher for longer" to "when will the Fed begin cutting rates?" The Fed's December meeting offered policy makers a chance to rebut the bond market's enthusiasm for imminent rate cuts. Not only did officials not pushback on the market's expectations, they revised their expectations to show a quicker pace of rate cuts in 2024 and 2025 than they had previously forecast in September. The Fed also forecast a Goldilocks scenario where inflation declines more quickly, unemployment is anchored, and GDP growth remains respectably between 1.5%–2.5% over the coming years, implying a belief in their own ability to manufacture a soft landing for the US economy.

After peaking around 5% in October, 5-year US Treasury yields have moved to the 3.90% range and the 5-year AA-rated municipal index fell to 2.40%. It has been a stunning move by the bond market in a very short period. Additionally, the Fed Funds Futures market is now pricing in nearly 150 basis points (1.50%) in rate cuts in 2024, this is double the Fed's projections of just 75 basis points in cuts. While the market has clearly made an about-face, we think that either the economy or inflation will have to slow to inspire the Fed to begin cutting rates.

The decline in yields led to solid returns for markets, with year-to-date performance ranging from +3% to +9%, based on maturity and credit ratings. In the short term, bonds look mildly overbought, but the narrative and the trend have changed, and yields appear to be headed lower over a relatively longer time horizon. We continue to think that current levels will look attractive by year-end 2024.

Fourth Quarter 2023 – Wealth Management Insights

International

Matt Clarke, CIMA®, VP, Senior Client Portfolio Manager

2023 made for a very interesting year and obviously did not end the way many expected. It also saw its share of significant events including (and not limited to) the Chinese spy balloon incident, a banking crisis, a boom in artificial intelligence (AI) technology, and the start of the Israel-Hamas war.

In the final quarter of 2023, international stocks picked up steam and rebounded from losses in the 3rd quarter. Stocks benefitted from the combination of easing inflationary pressures, fewer concerns about the potential of recession, and hope that central banks may begin to ease in 2024. Just as with the start of the year, **developed international outpaced emerging markets.** The MSCI EAFE (developed international), finished the quarter higher by 10.47% and the full year up 18.95%. Leading for the year in the developed international space, as well as all of Asia, was Japan. Japan continued to benefit from more accommodative monetary policy than any other developed country. The Japanese Nikkei 225 closed out the quarter 5% higher and the full year up over 30% – holding on to a 33-year high. Generally speaking, Europe also had a good year with the pan-European STOXX 600 Index closing in on a two year high, up 6.77% on the quarter and 16.63% on the year.

The MSCI Emerging Markets Index returned 7.84% on the quarter and 10.12% for the full year – weighed down by exposure to China. Despite a short-lived year-end rally, **China suffered another black eye** as the effects of the property crisis, weak consumer spending and high youth unemployment overshadowed the easing of Covid restrictions. The Shanghai Shenzhen CSI 300 index closed out the quarter lower by -6.81% and the full year down -9.14%, chalking up three straight years of losses. Even though emerging markets stocks closed out the year in positive territory, there was a mixed bag of winners and losers. Of note, Taiwan, Korea, and India all posted double digit gains for the year, while Thailand, the Philippines, and Indonesia all finished lower.

Finally, as expectations grew that central banks may begin to shift towards more accommodative monetary policy, global bonds gained. The Bloomberg Global Aggregate (measure of global investment grade debt) found footing and pulled itself out negative territory to close out the quarter up 8.10% and the year up 5.72%.

As we peer into 2024, we are mindful that several persistent headwinds and unknowns remain. As such, we are still very much committed to managing both risk and return. The wars in both Europe and the Middle East continue to rage on with no current solution in sight. The effects of monetary tightening by central banks have yet to be fully realized, and inflation (while trending in the right direction) could yield a few negative surprises. Finally, 2024 will be the **biggest global election year in history** with more than 60 countries going to the polls.

Additional and expanded information to this newsletter discussion may be obtained by contacting your relationship manager. We will be happy to expand our discussion with you to meet your individual requirements as a client of Wealth Management & Advisory Services.

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