Investment and Economic Update
Fourth Quarter 2023

Last year, stocks were buffeted by the Federal Reserve Board's aggressive rate hikes (the fastest since the 1980s stagflation era) and the reverse of the quantitative easing policies which, for a decade or more, flooded the markets with liquidity. There were persistent fears of a recession and market economists were comparing this perfect storm of headwinds to the declines triggered by the 2008 financial crisis. In one poll taken at this time last year, 85% of distinguished economists predicted a recession.

What happened? In a word, the pundits were wrong. Throughout 2023, particularly in the final quarter, the markets blew through the headwinds and posted unusually high gains nearly across the board.

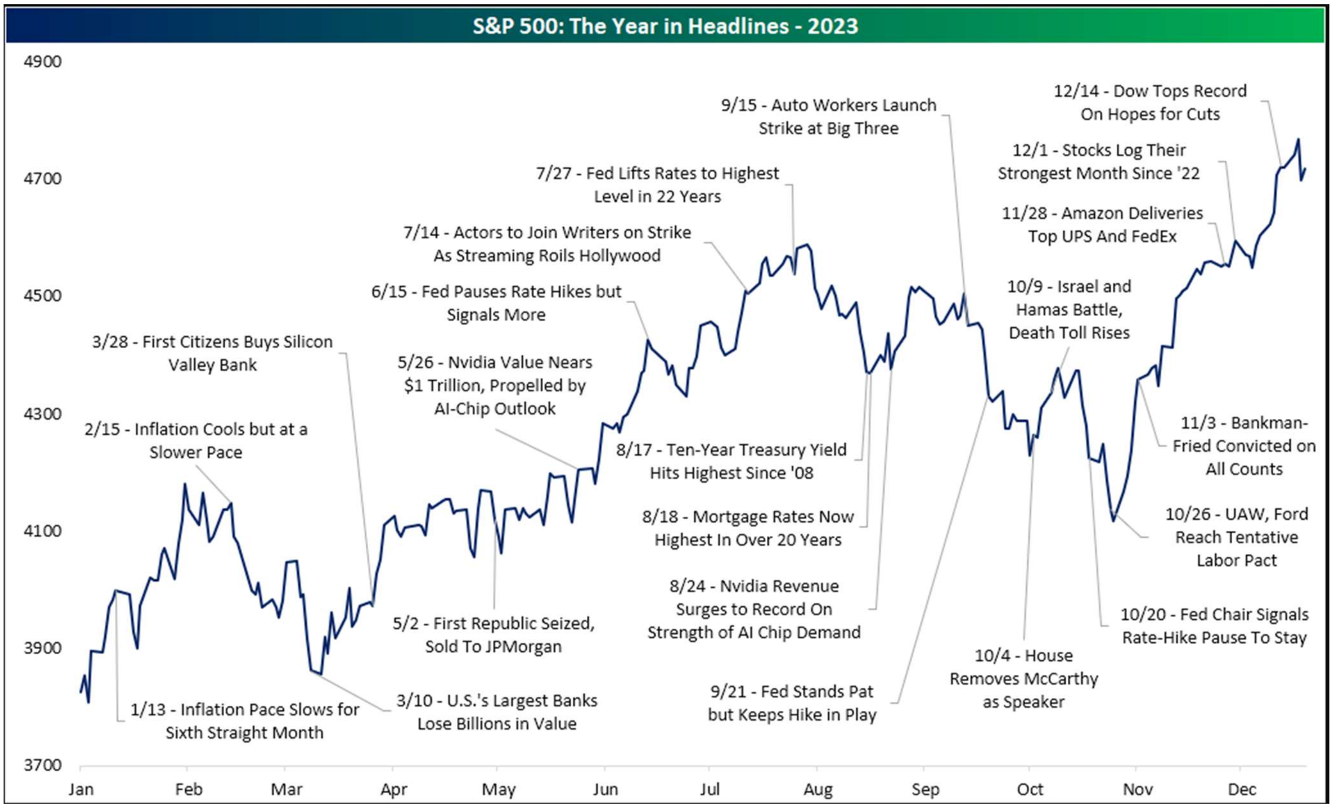
Looking at large cap stocks, the widely quoted S&P 500 index of large company stocks gained 11.24% during the year's final quarter and overall finished up 24.23% in calendar 2023. Meanwhile, the Russell Midcap Index finished the 2023 calendar year up 17.23%. The Russell 2000 Small-Cap Index posted a 15.09% gain in the past 12 months. The technology-heavy Nasdaq Composite Index was the biggest gainer in 2023; after dropping 28.27% of its value in 2022, it rebounded to gain 43.42% in 2023.

The foreign markets moved generally in lockstep with the U.S. gains. The broad-based EAFE index of companies in developed foreign economies gained 10.09% in the final quarter of 2023, to finish the year with a 15.03% gain in dollar terms.   In aggregate, European stocks were up 16.68% in 2023, while EAFE's Far East Index was up 12.77%. Emerging market stocks of less developed countries, as represented by the EAFE EM index, gained 7.04% in dollar terms on the year.

The dramatic interest rate movements in 2022, which led to unusually steep losses in bond portfolios, thankfully didn't carry over to 2023. Yields on 10-year Treasury bonds rose from 3.87% to 4.76% currently. 30-year government bond yields rose incrementally from 3.96% at this time last year to 4.03% as of the start of the new year. Five-year municipal bonds have dropped from a 2.56% annual rate down to 2.22% in aggregate, while 30-year munis moved from 3.63% at the beginning of the year to roughly 3.40% today.

2023 was undeniably an eventful market year, as shown by the chart on page 2. While the Fed was raising interest rates, three regional banks failed, and analysts cited the headwinds of interest rates and depositors making unusual runs on their lending institutions. Rising mortgage rates cooled the housing market, and Congress flirted with defaulting on the U.S. debt through headline-grabbing brinkmanship over the debt ceiling. Gasoline prices fell and a decline in manufacturing and industrial production flew under the radar.

The inflation rate was constantly in the headlines, as it steadily dropped from the near-10% range in the middle of 2022. Prices are still rising at a 3% annual rate, which is higher than the Federal Reserve target. The U.S. Central Bank is still engaged in quantitative tightening, shrinking its $9 trillion balance sheet by roughly $100 billion a month.



Perhaps the most under-noticed market story was how a very small number of stocks have come to dominate the robust returns of the U.S. indices. Seven stocks--Apple, Microsoft, Amazon, Nvidia, Alphabet, Meta Platforms and Tesla--accounted for 65% of the returns of the S&P 500, and because the index is capitalization-weighted (larger stocks count more than smaller ones), they now make up 28% of its weighting. The other 493 stocks in the large cap index, in aggregate, were actually underperforming.

For people with very long memories, this performance by the so-called 'magnificent seven' brings back echoes of the 'Nifty Fifty' bubble in the 1960s and 1970s, when a small number of stocks (Xerox, IBM, Polaroid, Coca Cola, etc.) rose for decades, and seemed poised to rise to the moon. The shorthand version of the ending is that investor expectations of more of the same cause them to become overpriced, and they crashed in the 1973-74 bear market.

Will the future bring a similar result? Of course, we don't know, but perhaps we can take comfort in the fact that we're not alone. Most of the predictions made a year ago at this time turned out to be wrong, and they were offered by economists and others with fancy degrees and a lot of social media facetime. It's becoming increasingly possible that the Fed--viewed as reckless for most of last year, will finally get inflation under control and achieve that mythical ‘soft landing’ for the economy. It's possible that artificial intelligence and a higher-tech economy will drive those seven stocks higher in the foreseeable future.

But whenever you see complacency, it's time to be wary. A recession is still possible, and the markets are priced as if there is a certainty of good economic and company profit news in the year ahead. The unemployment rate has managed to stay at near-record lows for a surprisingly long time, and consumer spending continues to surprise on the upside. There is no guarantee that will continue. It's worth noting that the S&P 500 index is currently sporting a 25.35% price-earnings ratio, which means that investors are paying between 71% and 129% more for a dollar of earnings today than they have over the long-term history of the markets.

These tea leaves aren't telling us much, but in general, when markets are pricey and everybody seems to be expecting good news, it's often a good time to stay cautious and control our expectations. Economists predicted a recession, which would have triggered a stock market decline. Instead, the economy remained steady and stock prices recovered from the down year of 2022. Today, a recent poll of economists showed that half of them now predict a soft landing, with more positive market returns going forward. Will the analysts and pundits be wrong again?

Below, we've summarized some of the widely quoted indexes for your reference. As a reminder the challenge is, the DJIA is not the same as the S&P 500, which is not the same as the NASDAQ – and none of these indexes perfectly match your own distinct mix of assets and their expected returns, especially if you own a globally diversified portfolio with exposure to stocks and bonds, large and small companies, value and growth companies, and U.S. and non-U.S. based companies. The following returns are quarter and year-to-date; respectively:

S&P 500: 11.24%, 24.23%
Dow Jones: 12.48%, 13.70%
NASDAQ Composite: 13.56%, 43.42%
Russell 2000 (Small-Cap): 13.55%, 15.09%
MSCI EAFE (International): 10.09%, 15.03%
Barclay's Capital US Aggregate Bond: 6.82%, 5.53%