Wealth Enhancement®

Review of the Markets

Fourth Quarter, 2023

Index	4th Qtr Return	YTD Return
S&P 500	11.69%	26.29%
MSCI ACWI Ex USA IMI	9.81%	15.62%
Bloomberg Bond Index	6.82%	5.53%
Consumer Price Index	0.45%	3.30%

Market Commentary

Stock and bond markets finished 2023 in an impressive fashion. The S&P 500 increased 11.7% in the fourth quarter, finishing the year up 26.3%. Smaller capitalization stocks as measured by the Russell 2000 increased 14% for the quarter, gaining ground on large cap stocks, but finishing the year at a lower return of 16.9%.

International stocks also did well, increasing 9.8% during the fourth quarter and 15.6% for the year.

Bonds increased by 6.8%, as the 10-year Treasury yield retreated from 5% to below 4%, marking the best quarter in the bond market since the 1980s. This was sufficient for the index to finish the year up 5.5% after a historically bad 2022.

After two consecutive double-digit return years, the Bloomberg Commodity Index fell 7.9% as inflation pressures eased in much of the world.

Economic Outlook

Markets seem more convinced than ever of a “soft landing” scenario in the economy, whereby the U.S. Federal Reserve (the Fed) will have increased interest rates sufficiently to calm inflation, but not so much that they cause a recession. Recent economic data tend to support this, at least at the initial headline number level.

Consensus shifted over the course of the year from concerns of imminent recession to the pricing in of a soft landing. This shift accelerated in the fourth quarter as markets were no longer pricing in additional rate hikes and ended the quarter pricing in a number of rate cuts by the Fed in 2024. This culminated in December during the final Fed meeting of the year, in which the Fed acknowledged (1) the vast majority of Fed policymakers expect rates to be lower by the end of 2024, (2) substantial progress on the inflation front, and (3) growing concern about the other part of their dual mandate (employment). Markets are currently pricing in 1.25% to 1.50% of rate

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cuts throughout 2024. Expectations of lower interest rates in 2024 were certainly one of the driving factors in the rally in both stocks and bonds in the fourth quarter of 2023.

Markets continue to place above-average valuations on historically average earnings growth expectations for stocks in 2024. While it is certainly possible that stocks will continue to do well, we think this elevated valuation dynamic lowers the potential return for markets. It is reasonable to think that, if we are late in the economic cycle and the labor market does not hold up, these earnings growth estimates will prove to be too high. Further, if interest rate cuts do not materialize at the rate markets currently expect, this could lead to reduced valuations for stocks. If both of these outcomes combine, this could result in a stock market sell-off.

In an environment of average expectations for earnings growth, above average valuations, and expectations for monetary policy to become less restrictive, bond yields remain high relative to the past 15 years. Valuations in high-quality corporate bonds (as measured by the difference in yield between these bonds and similar maturity Treasury bonds) are about average, signaling that the bond market is not bracing for recession at the moment.

Inflation did not decelerate as much as markets had hoped, but meaningful progress has still been made towards the Fed's target of 2%. This has been accomplished with, to this point, small increases in the unemployment rate.

The labor market continues to walk the razor's edge between a mild softening and a problematic increase in unemployment. We've noted previously that only a small uptick from a low base in the unemployment rate has been sufficient in the past to confirm that recession has begun. The "Sahm Rule", named after former Fed Economist Claudia Sahm, has become a topic of great debate in financial markets. For those unfamiliar, per the St. Louis Fed, the "Sahm Recession Indicator signals the start of a recession when the three-month moving average of the national unemployment rate (U3) rises by 0.50 percentage points or more relative to the minimum of the three-month averages from the previous 12 months." [1] The indicator, which has an excellent track record of signaling the start of a recession, reached 0.33% during Q4, just narrowly avoiding the 0.5% increase that would indicate a recession has begun. We continue to monitor this measure closely; however, there are few signs of confirmation one way or the other at this point. .

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[1]Sahm, Claudia, Real-time Sahm Rule Recession Indicator [SAHMREALTIME], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/SAHMREALTIME, January 16, 2024.

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