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Market Overview

All major stock indices experienced a fourth quarter rally as the 10-year bond yield broke down through 5%. Crude oil also declined, easing the advance of the consumer price index (CPI). The Russell 2000 Index[1] led the fourth quarter stock gains finishing up 14.03%, with the Nasdaq Index[2] and the S&P 500 Index[3] trailing by 13.79% and 11.69%, respectively.

During the fourth quarter of 2023, real estate was the best performing sector gaining 18.83%, followed by technology at 17.67%, and financials by 13.91%. In terms of performance, U.S. small cap stocks led the way during the fourth quarter as the market rally began to broaden out.

The Federal Reserve (the "Fed") paused interest rate increases in the fourth quarter and signaled three potential rate cuts for next year from its current 5.25% to 5.50% range. It is unclear when rate cuts will occur as the Fed is still data dependent, waiting for more data to reinforce the decline in inflation which has subsided in most categories. However, service inflation remains sticky, and the rental component significantly lags actual declines market rents. But looking forward, the catchup in that category should put meaningful downward pressure on the Consumer Price Index (CPI), and likely affect the timing of the Fed lowering their Federal funds target.

Bond prices rose during the quarter as yields fell from the 5% mark on the ten-year Treasury bond. Within fixed income, high yield bond prices rose and defied expectations driven by resilient fundamentals and lower than expected default rates. Meanwhile, the broader fixed income market rallied late in the year, with the U.S. Aggregate bond Index[4] rising 6.75% as investors were comforted by the Fed's dovish shift.

Turning to international markets, developed market equities outperformed emerging market stocks. Corporate governance reforms in Japan, better-than-expected progress on inflation in Europe, and resilient earnings boosted developed market equities to a 10.71% gain in the fourth quarter. Emerging market equities ended the quarter with a more modest 8.00% gain as the downturn in China offset strong gains in Taiwan, India and Korea.[5]

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U.S. Equity Returns Table
Source: Tamarac

Index	Q4 2023 Returns	2023 Returns
Dow Jones	13.09%	16.18%
S&P 500	11.69%	26.29%
NASDAQ	13.79%	44.64%
Russell 2000	14.03%	16.93%
MSCI World	11.03%	22.20%

U.S. Treasury Yield Table
Source: Treasury

	12/2023	12/2022	12/2021
3 month	5.40%	4.42%	0.06%
2 year	4.23%	4.22%	1.26%
5 year	3.84%	3.99%	0.98%
10 year	3.88%	3.88%	1.52%
30 year	4.03%	3.97%	1.90%

Other Indices Table
Source: Morningstar

	Q4 2023 Returns	2023 Returns
Gold (GLD)	11.50%	12.69%
Brent Oil (BNO)	-14.84%	-3.43%
U.S. Dollar Index (UUP)	-3.06%	3.63%
Int'l Equity Markets (EFA)	10.71%	18.40%
Emerging Equity Markets (EEM)	8.00%	8.99%

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What's in Store for '24?

Well, that depends on who you talk to, and what you are reading. Business Insider polled 13 leading firms on their outlooks for the S&P 500 for 2024. Of the 13 firms, the average return was a gain (from the close on December 31, 2023-December 31, 2024) of 2.2% including dividends, and the median return was 4.8%. Taking out the high return estimate (14.6%) and the low return (-28.9%) projected a 2024 median return of 6.3%.[6]

After the 26% S&P 500 return in 2023, another 5-6% would seem acceptable given the potential headwinds of inconclusive military conflicts, election uncertainty, and the extended nature of the bond and stock market rallies. The more bullish forecasters cite the meaningful gains in productivity from the Artificial Intelligence (AI) boom, a more rapid approach to the Federal Reserve's 2% inflation target, and a soft landing for the economy, emphasizing continued labor market strength, and better than anticipated corporate earnings. Bearish firms expect a weakening consumer, elevated equity valuations, extreme overvaluation, and higher odds of a recession than the consensus.

There are some historical guideposts for subsequent returns when stocks reach previous peaks as they have now. As mentioned in last month's ("November to Remember") market letter, in a non-recession environment, when stocks reach their previous peak, they go on to return an average of 11% in the ensuing 12 months. And according to Ned Davis Research, when stocks reach a new high after pulling out of a bear market, and the S&P 500 reaches a previous peak, in 13 out of 14 cases its median return was 13.4% in the next 12 months.[7] Lastly when the Federal Reserve first cuts the Federal funds rate, if the economy is not in a recession, the S&P 500 was ahead, not surprisingly, by 11% over the next 12 months. The caveat here is that in three of the eight cases examined, there was a recession and the 12-month return was -12%.

These are not exact analogues of the current environment, but do give a market behavioral backdrop to how investors have reacted to similar economic and market conditions in the past. We have always been impressed with "market memory" where past market signposts seem to have a repeatable linkage to current market behavior. We'll see if the above outcomes follow that path.

For us, we were constructive for most of last year. Though our view of the magnitude of the S&P 500 Index return was for mid to high single digits was off the mark, we viewed the disinflation that occurred to be as long in length and size as the runup to its peak in June 2022, and that would provide the tinder for positive returns in 2023 and a Federal Reserve pause in their tightening policy. Our strategy was to stay invested and not trade around volatile short-term peaks and troughs, continuing to emphasize growth at a reasonable price.

Our view for this year is that the Fed needs to lower rates before mid-year to cushion the developing economic slowdown in consumer spending, the waning effect of the post-Covid fiscal largesse, and the emerging deflationary effects of the past negative growth rates in the money supply. As the year moves on, deflation may be the new word in the market lexicon. Staying tight too long is the biggest risk to stock and bond returns in 2024. And, the Fed is well aware that they need to act before the heart of the primary politicking season in May and June, in order to stay out of the way of partisan threats to their independence.

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Disclosures

Sources:

1. The Russell 2000 Index is a small-cap U.S. stock market index that makes up the smallest 2,000 stocks in the Russell 3000 Index.
2. The Nasdaq Composite is a stock market index that includes almost all stocks listed on the Nasdaq stock market and is heavily weighted towards companies in the information technology sector.
3. The S&P 500 Index is designed to be a leading indicator of U.S. equities and is commonly used as a proxy for the U.S. stock market.
4. The Bloomberg U.S. Aggregate Bond Index is a broad-based index used as a proxy for the U.S. bond market.
5. The MSCI World ex USA Index captures large and mid cap representation across 22 of 23 Developed Markets countries (excluding the U.S.) and 24 Emerging Markets countries.
6. Source: Business Insider. https://markets.businessinsider.com/news/stocks/2024-stock-market-investment-outlooks-wall-street-pred
7. Source: Ned Davis Research. https://finance.yahoo.com/news/asia-shares-rise-us-stocks-223518480.html#:~:text=The%20S%26P%%2020500%20has%20outperformed,by%20a%20median%20of%2013.4%25

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