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4th Quarter 2023 Review

2023 proved to be a resilient year for the markets and the economy. Stocks and bonds both staged year-end rallies after experiencing elevated levels of month-to-month volatility during the year. For the stock market, the S&P 500 fell in each of the months from August to October but turned higher in November (up 9%) and December (up 5%) on an improved narrative from the Federal Reserve that they may be finished hiking interest rates in this cycle. The bond market experienced similar volatility during the year, with prices declining for 6 months from May to October but turned sharply higher in November (up 4.5%) and December (up 3.4%). The narratives driving the market were equally volatile. Early in the year it was the narrow leadership of technology names driven by excitement around Artificial Intelligence. The market rally then broadened out into the summer, but then narrowed again in the fall as interest rates on the 10-year treasury topped 5%. Most asset classes were on pace for negative year to date returns by early November. That all changed with the powerful year-end rally in assets for the rest of November and all but the last trading day of December.

The returns for the major averages for the year 2023 and 4th Quarter were as follows:

The Dow Jones Industrial Average gained 13.70% (up 12.48 in Q4), the S&P 500 was up 26.29% (up 11.69% in Q4), the Russell 2000 Small Cap Index rose 15.15% (up 13.6% in Q4), the NASDAQ soared 43% (up 13.5% in Q4). International equities saw gains that lagged the U.S. with emerging market stocks rising 9.85% (up 5.58% in Q4) while the MSCI EAFE Developed International Index rose by 16% (up 5% in Q4). The broad U.S. bond market was higher with the Aggregate Bond Index up 5.5% (up 6.8% in Q4).

From a style perspective, in a reversal of what we saw last year, growth stocks outperformed value stocks with the Russell 1000 Growth Index gaining 41% while the Russell 1000 Value Index rose only 8.7%.

The U.S. economy has seen inflation come down sharply while unemployment remains low. This has bolstered the view that the Federal Reserve has achieved a so-called, “soft landing” by raising rates by enough to bring down the level of inflation without causing a severe problem for the economy and the labor market.

The growth rate in the economy as measured by the Leading Economic Indicators is decelerating, but not collapsing. The big question on every investor’s mind now is whether the lagged nature of the Fed’s actions will cause a recession in 2024. We recognize that there is a risk of recession next year but would also say that the most likely outcome would be a rather mild one. This stems from the idea that it is hard to have a severe recession when there are not sectors of the economy that are at excessive levels that need purging. David Kelly of JP Morgan sums it up best with his economic analogy to falling from a building, saying “it is very hard to get hurt falling from a first story window.” This does not mean that certain financial assets may not need purging based on long-term valuation measures. So that is where we will spend most of our mental energy.

The consensus view now that the Fed has signaled a potential pivot in rate posture, is for five to six rate cuts beginning in March of 2024. Whether this proves to be on target or too optimistic will have implications for market pricing, as it is clearly looking for these cuts to materialize and the "soft landing" for the economy to be proven correct. If the rate declines that have been priced in do come to fruition, it will be important to watch for why these cuts are occurring. There could be a much different response from markets based on whether this is from the inflation fight being declared over, or from a deceleration in economic activity and the follow-on impact this could have on corporate earnings.

Staying vigilant and being conscious of where complacency has led to pockets of overvaluation risk will be paramount if prices continue to rally on the Fed narrative.

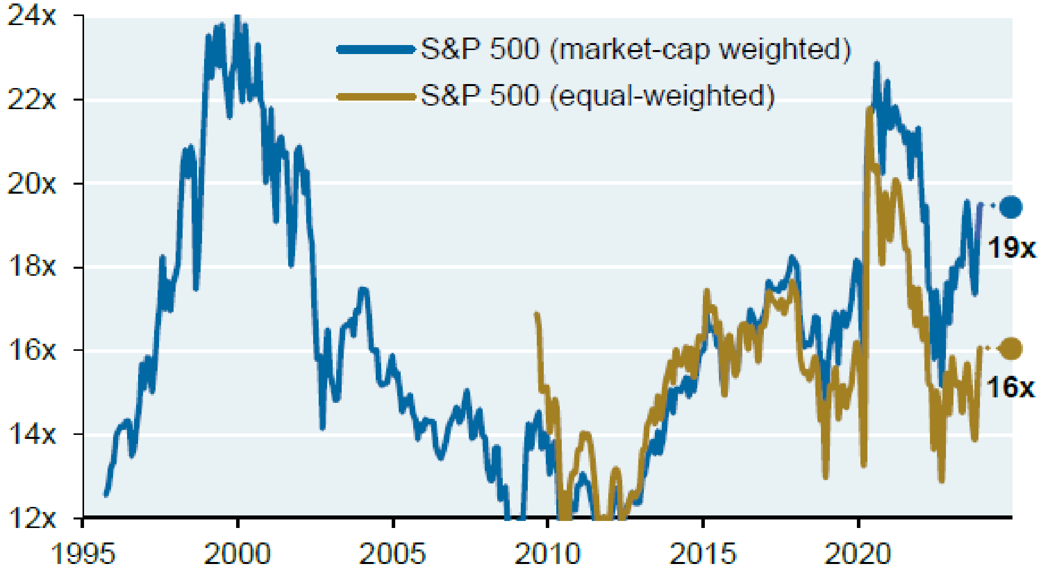
The broad stock market remains dominated by a handful of technology stocks, commonly referred to as the "magnificent 7" (Microsoft, Alphabet, Apple, Nvidia, Tesla, Amazon, and Meta). This domination has led to these names accounting for as much as 30% weight in the S&P 500 Index.

This is the most concentrated market backdrop for stocks since the tech bubble peak in 1999. The ten largest capitalization names in the index accounted for 75% of the index return in 2023. These top ten have forward PE ratios ranging from near 18 x to over 61 x, with a median PE ratio of 27 x. This compares to the median PE ratio of 17 x for the other 490 companies in the S&P 500. Hedge fund crowding into these names as well as the high flows into passive index strategies exacerbate this situation and can pose greater risks if enthusiasm leads to complacency, and then to excessive valuations that become unsustainable.

It is important though to realize that valuation differentials can and do exist even in an expensive broad market. The chart below from JP Morgan Asset Management points to the market-cap weighted S&P 500 Index being closer to the higher end of its range, while the equal-weighted version of that index is more modestly valued.

S&P 500 valuations

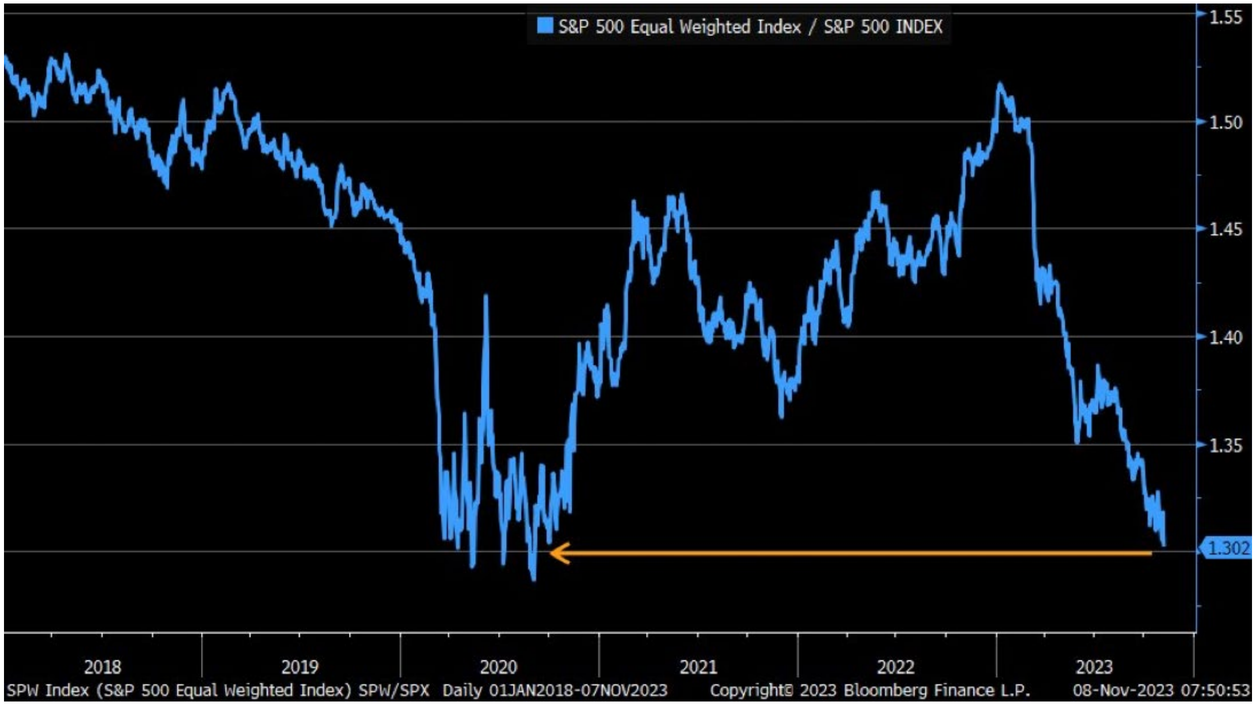
Forward P/E multiple



Source: FactSet, JPMAM, December 26, 2023

As you move away from the largest names, there are many pockets of the market that are trading at even better valuations than what is offered by the equal-weighted index. (Mid Cap and Small Cap stocks are even more modestly valued at 15.7 x and 14.7x respectively). This reinforces our view of the long-term performance potential of the businesses we own that are priced in a much better valuation zone, offering a more attractive risk/reward. The wide divide that has opened up between the largest cap stocks and smaller cap stocks, is an opportunity for long term investors, but selectivity is key when going down in size, as nearly 50% of the Russell 2000 Small Cap Index members are not profitable. Further, if we do go into a recession, that number of unprofitable companies is likely to rise further. A focus on quality of earnings and cashflows, as well as valuation and balance sheet health, makes much more sense to us than just buying it all.

We see opportunity when great businesses are priced cheaply just because the market is focusing its attention very narrowly. The chart below from Schwab Chief Market Strategist, Liz Ann Sonders, shows that the ratio of the equal-weighted S&P 500 relative to the cap-weighted S&P 500 has fallen to the lowest level since September 2020. When the line is falling, the market cap index (which has that 30% concentration in the top seven names) is outperforming the equal weight index (which removes the skew of the top weighted names).



The underperformance of the average stock relative to the largest stocks went on for much of the year as seen in the falling line on the chart. While past performance is no guarantee for future performance, we have seen such extreme periods in the past reverse direction and move higher-- meaning the market leadership broadens out and more stocks participate in rallies. We would expect this to be an environment where high quality stocks outside of the very largest perform well.

As equity managers investing in a more concentrated portfolio of quality businesses across multiple sectors and market capitalizations, we are not surprised to lag the market cap weighted index in periods where it is being led by a narrow handful of richly valued names that pose too much price risk in our estimation. It goes with the territory when having a valuation discipline and an adherence to a proven process and philosophy. The market strength in the last two months of the year experienced a broadening out with more participation from sectors outside of technology, resulting in an outsized rally for most of our equity holdings. We own our holdings for the long run with the expectation that price will follow quality fundamentals over time, filling the valuation gap that was identified upon purchase. Companies we own in the healthcare and industrial sectors for example trade at attractive valuations with earnings stability and favorable long term demand trends such as demographics, technical innovation, and infrastructure spending and reshoring of the manufacturing base in the U.S.

The bond market is transitioning from the rapid increase in interest rates that saw the 10-year treasury yield top out at 5% in the fall of this year and then proceed to decline right back to the level where it started the year at 3.88%. In between, there was of course a lot of volatility. The last Fed rate hike was in July, and they have signaled at their last two meetings that they may be finished. Again, the path forward for yields will depend largely on the ultimate trajectory of inflation and the economy compared to market expectations that have been priced in. Additionally, the higher supply of treasury debt that will be coming to fund increasing deficits will be a factor as well. Given the election year and the prolific spending on both sides of government, the Treasury will need to issue more paper to fund the government- and the cost of this funding has gone up dramatically in the last 2 years. We like a diversified approach to fixed income portfolios with varying maturities and up in quality to capture the higher yields being offered across the investment grade bond markets while keeping some powder dry for extending duration or taking on more credit risk when volatility presents good risk-adjusted opportunities. Being too overweight in cash can limit future returns when the Fed rate cycle turns. U.S. intermediate term bond returns have historically exceeded the returns of cash (3-month T-Bills) on 6-month, 12-month and 18- month periods after the Federal Reserve ends a rate hiking cycle.

In alternatives, we favor having a good mix of strategies to provide broad diversification benefits and downside protection. A properly constructed alternatives portfolio can provide stability and diversification in periods where stock and bond correlations move together. While 2023 reversed much of the correlation that hurt traditional portfolios in 2022, having alternatives in the mix adds a level of protection when these inevitable periods arise. The idea here is not to predict when such periods are going to happen, but rather build in the diversification of alternatives as part of a strategic, long-term allocation to be there to protect when needed and participate along with markets in a risk-managed approach.

The market gyrations of the last 3 years emphasize the importance of having a long-term investment policy statement (that fits your personal financial planning goals) and sticking with it and not succumbing to emotion during periods of market volatility. As mentioned in the opening paragraph, the market narratives shifted dramatically throughout the year and prices were volatile. In a matter of weeks during the 4th quarter, many asset classes went from negative to positive returns. Having the staying power and fortitude of knowing what is owned and why it is owned in a diversified portfolio served investors well during such a period.

A well-constructed portfolio of quality assets with diversification across and within asset classes should offer a level of comfort to investors in its resiliency. Markets are inherently unpredictable in the short run, and emotions have the potential to overcome discipline. We are fortunate as a firm to have an investor base of clients who embrace this. For that we are grateful for your trust and confidence.

We wish everyone a Happy, Healthy and Prosperous New Year.

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