COMMENTARY

Q4 2023

The final quarter of 2023 was a remarkable one, as a slowing economy continued to create jobs, strong 3rd quarter GDP numbers of 4.9% were revised further upward to 5.2% (an unsustainable pop), and the Federal Reserve began to signal that they would be more accommodative to economic growth in the new year. Markets responded in turn, finishing out the year with an accelerating rally, with the S&P 500 up over 4% in December alone.

Entering 2024, the big question in equity markets is that of valuations. Companies generally stated higher profits than earned through the reversals of accruals and bad debts built into their 2021 – 2022 balance sheets. The question becomes how much of the market returns seen in the 4th quarter were borrowed from a 2024 where interest rate reductions are expected but haven't happened yet. Interest rates across all maturities from 2 year through 30 year have dropped dramatically (80 basis point range) to reflect more realistic real rates of return (nominal rates less inflation) given optimistic expectations for the economy. With the inflation data continuing to show declines from peak levels, the market is pricing in significant interest rate cuts over the course of 2024.

Some perspective: 2020 was the Covid-19 year with the Government lowering interest rates to 0%, passing a massive PPP/CARES package for businesses survival, and the Federal Reserve expanding its balance sheet by providing $120 billion per month in liquidity. The easy money created led to the 2021 – 2022 years of recovery, with supply shortages and a higher velocity of money (spending) thus leaving inflation surging to heights not seen since the late 1970s. Companies in all industries raised prices at will and bonuses and compensation levels climbed at most companies as profits and cash flow soared through 2021 and the beginning of 2022. Through accounting techniques like realizing bad debts, inventory valuation adjustments and others, corporations were able to put away some of these earnings for a rainy day and decided to unwind those and use them in 2023. Going into 2024 less earnings surprises are expected, and with the expectation that borrowing will become less expensive, so is a return to more initial public offerings and mergers and acquisitions that were closed off in 2023.

Broader-based U.S. economy successes are possible regardless of wars fought or which candidate becomes President. The resilience of the U.S. economy remains stunning. The tech-heavy, market weighted S&P 500 actually underperformed the smaller capitalization stocks in the fourth quarter creating a broader-based rally in stocks that we have not seen for some time. However, the behavioral versus fundamental side of the picture is disconcerting. The fear of getting killed in the stock market crowd (the pessimists and the skeptics) have been drowned out by the fear of missing out crowd (the optimists and dreamers) at present. There is plenty of optimism and rate cutting scenarios being offered by the media and greed has supplanted fear for now.