Q4 2023 Market Update

THE QUARTER IN BRIEF

Investors enjoyed broad-based relief in the fourth quarter. After rising sharply in the second and third quarters of 2023, rates peaked in the fourth quarter fueled by Powell's pivot at the December FOMC meeting. Similarly, oil prices peaked in late September and declined sharply throughout the fourth quarter. During the fourth quarter investors bid on cyclicals, small caps and lower quality names, all laggards during the first three quarters of the year. With the volatility in rates during the year, surprisingly, the 10-Year Treasury yield ended the year at the exact rate at which it began the year. The rally in rates led to the best 2-month rally in bonds in over 40 years!

	1M	QTD	YTD	1-YR	3-YR	5-YR	10-YR
S&P 500	4.53%	11.68%	26.26%	26.26%	9.98%	15.67%	12.02%
NASDAQ	5.62%	13.84%	44.70%	44.70%	6.07%	18.81%	14.87%
Dow Jones Industrial	4.93%	13.09%	16.18%	16.18%	9.38%	12.47%	11.07%
MSCI EAFE	5.33%	10.47%	18.95%	18.95%	4.63%	8.80%	4.88%
MSCI EM	3.87%	7.84%	10.12%	10.12%	-4.81%	4.02%	3.01%
U.S. Barclays Agg.	3.83%	6.82%	5.53%	5.53%	-3.31%	1.10%	1.81%
Investment Grade Bonds	4.85%	9.94%	9.45%	9.45%	-3.99%	2.92%	3.19%
High Yield Bonds	3.81%	7.21%	12.89%	12.89%	1.73%	4.79%	4.00%

Source: Bloomberg. Data as of 12/31/2023. Returns include Dividends. Returns over 1YR are Annualized.

DOMESTIC MARKETS

The U.S. economy saw impressive resilience last year, with the first three quarters showing above trend real GDP growth. Easing inflation and improved prospects for growth have helped fuel optimism for a soft landing. However, a quick look across each sector of the economy suggests that economic momentum in the year ahead is set to be moderate, at best.

Business spending held up better than expected last year despite tighter lending standards, supported by increased spending on intellectual property with greater emphasis on building and integrating artificial intelligence capabilities. Tailwinds from AI spending as well as federal government support for semiconductor manufacturing should persist in 2024. However, increased caution among lenders and slowing corporate profits could still constrain growth.

Consumers have remained resilient, supported by a tight labor market and rising real wages. That said, there are some signs of weakness. While revolving credit as a share of disposable income does not look overextended, delinquencies are rising, and younger households are showing signs of increased financial stress. As labor market conditions continue to loosen and lending standards remain tight, consumer spending should grow at a slower pace going forward.

The housing market appears to have stabilized, albeit at low levels, as tight housing supply and steadying mortgage rates are signaling that the worst is behind us. Trade should be a mild drag on the economy as a strong dollar and sluggish global growth weigh on exports. Meanwhile, government spending growth should slow as gridlock in Washington limits further stimulus.

Overall, the U.S. economy should continue to grow at a moderate but slowing pace from here. That said, a slower-moving economy will be increasingly sensitive to shocks. Whether it be the U.S. election, higher policy rates, significant geopolitical tension, or something else entirely, risks remain that could push the economy into recession in 2024.

FOREIGN MARKETS

Strong equity market performance in 2023 was not only a U.S. phenomenon. International equities also experienced impressive growth, with the MSCI All Country World Index climbing more than 10%. Taking a quick trip around the globe, Japanese equities had a very strong year, rising roughly 16% in dollar terms, as an improved interest rate backdrop and corporate governance reform propelled new enthusiasm from investors. Elsewhere, promising fiscal reforms and strong economic momentum bolstered the case for Indian equities, which similarly rose over 16%. In Europe, markets also saw strong performance in the first half of the year as the end of negative interest rates supported banks and economic activity stabilized from Russia-induced energy shortages.

Looking ahead, while the global growth backdrop looks set to slow, there are still strong opportunities outside of the U.S. for long-term investors, and at better valuations. International equities continue to trade at a steep discount of over 30% compared to U.S.

equities, near 20-year lows. International equities also offer greater income, with dividend yields trading at a 1.8% spread above that of U.S. equities.

Combine this attractive entry point with structural tailwinds, attractive relative fundamentals and a weakening dollar, and the year ahead could be a much more favorable environment for U.S. based investors investing overseas looking to diversify and add exposure to important global secular trends and themes.

FIXED INCOME MARKETS

In bond markets, volatility was a defining feature of 2023 as investors grappled with resilient economic data, a hawkish Fed and various technical factors. The yield on the 10-year Treasury climbed by nearly 170 bps from early April to late October, before expectations for a soft landing and an end to tightening helped drive the yield lower by more than 100 bps in less than two months. Even with this move lower, current yields across the fixed income landscape still offer investors much better income and total return opportunities than existed a year ago.

Nearly fixed income sectors are trading well above their 10-year median yields. Core fixed income provides attractive yields above 5%, while leaning into riskier asset classes, like high yield, can provide yields north of 8%. Moreover, with peak interest rates likely behind us, bonds also offer the potential for price appreciation in the event of lower rates and diversification benefits as lower rates coincide with a potential recession.

LOOKING FORWARD

The equity markets are happy to support a soft-landing thesis for now as the bond market is just taking economic weakness as a reason to send yields lower. However, the mathematical truth is that it is impossible to know whether we are just passing through growth rates consistent with a soft landing before slowing into a recession or whether the economy will stay at growth rates similar to today.

CoreSat Model Update

Core Allocation

The core allocation has been adjusted to incorporate investments that provide capital efficiency, allowing us to retain core stock and bond allocations in addition to the satellite allocation. This way we are not reducing core exposure in either equities or bonds by introducing alternative investments. Taken together, we believe this solution provides tremendous flexibility in portfolio design and diversification.

For domestic equities, focus on broad index exposure with tilt toward quality names.

Outside of the U.S., Similar to domestic equities, focus on broad index exposure with a tilt toward value and quality names.

Fixed income, with the recent drop in yields, we continue to focus on short duration, taking advantage of the sweet spot with regards to yields.

Satellite Allocation - Tactical

During the quarter both global equities and bonds produced positive returns. Managed futures – as measured by the returns of the Société Générale Trend Index (“NEIXCTAT”) – posted a -5.03% return. While global equities and U.S. Bonds make up the core of the portfolios, the managed futures overlay contributes the majority of the portfolios active risk. The satellite allocation consists of managed futures and tactical trend following strategies. The combination provides diversified returns outside of traditional equities and bonds, along with volatility management. We prefer using tactical strategies due to their all-weather go-anywhere approach, which will typically produce better risk adjusted returns over time. The combination of core and satellite allocations are designed to provide a robust approach that diversifies across geographic regions, asset classes, and investment styles.

Andrew Corradetti, CMT
Chief Investment Officer

CITATIONS: Newfound Research, JP Morgan Asset Management, YCharts, Bloomberg

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