Market Update: Q4 2023

The fourth quarter was a fitting end to a remarkable and volatile year in the stock market. Both the financial markets and the economy showed incredible resilience after a devastating 2022, but the U.S. stock market's strong 2023 was hard-fought, with performance concentrated in the largest, most profitable stocks.

At the start of Q4, the S&P index had retreated from its July high-water mark and was on a downward slide. This halted on Nov. 1 when Federal Reserve Chairman Jerome Powell stepped to the podium with comments that ignited a rally spanning all asset classes and lasting through the end of the year.

Key Takeaways

- Stocks soared in Q4
- U.S. markets and economy showed their resilience
- The Fed held fast on rates, signaling a possible pivot
- Breadth is improving and small caps are coming alive

INDEX	Q4 2023	1-YR. TOTAL RETURNS
S&P 500	11.7%	26.3%
Russell 2000 Small Cap	14.0%	16.9%
MSCI EAFE - International	10.5%	18.9%
MSCI Emerging Markets	7.9%	10.3%
Bloomberg US Agg Bond	6.8%	5.5%

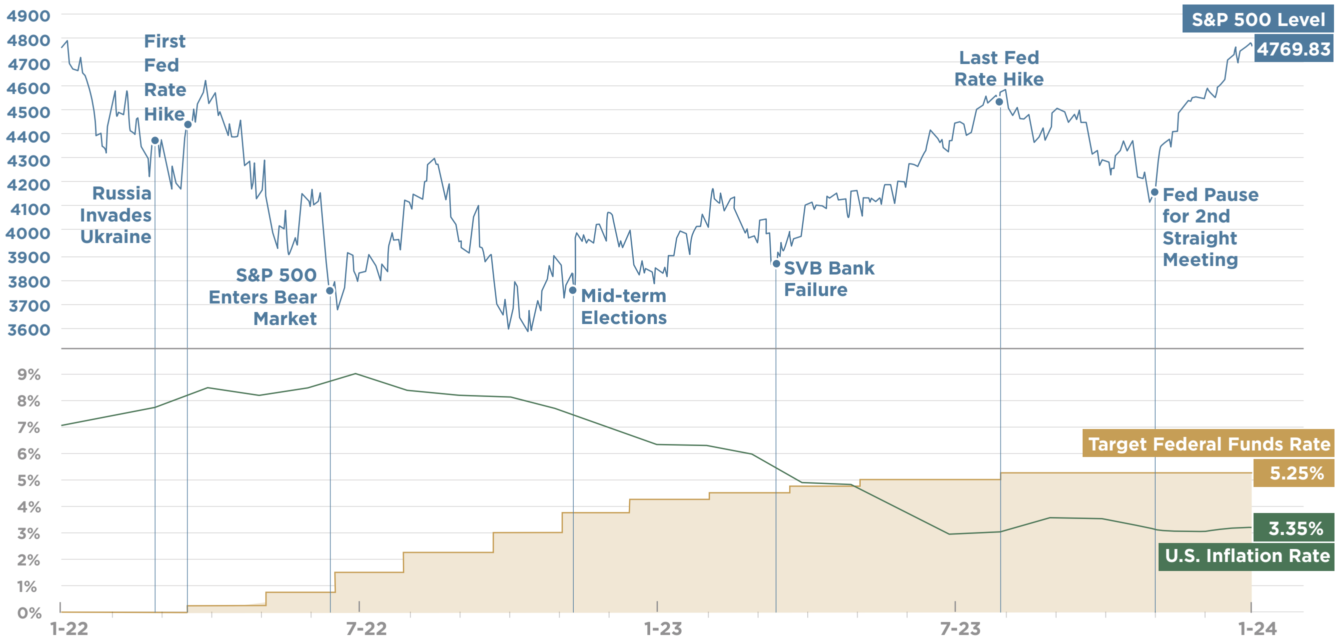
SOURCE: BLOOMBERG

A Long, Strange Trip

To frame why his comments were so impactful, we need to step back a few years. Starting in 2020, the coordinated government stimulus and zero-interest rate policy designed to stabilize the economy during the pandemic sparked inflationary conditions not seen for 40 years. In 2022, the Fed applied the brakes on inflation by aggressively raising interest rates to slow the economy; and the result was a massive sell-off across stocks and bonds. The Fed kept raising rates until the second half of 2023 when, despite tight labor markets and robust consumer spending, inflation showed signs of moderating.

The phrase 'don't fight the Fed' is one of the more durable axioms in investing. When the Fed makes it their mission to slow the economy and influence markets, they tend to get their way. Their interest rate hikes had the desired effect of slowing the economy enough to stabilize prices, but the consequent historic bond sell-off caused turmoil in the banking sector, including the failures of SVB and First Republic Bank. Higher interest rates also contributed to three consecutive quarters of negative year-over-year S&P 500 earnings growth ending in September. So, when Fed Chairman Powell announced on November 1 that the committee had voted to leave rates unchanged for its second consecutive meeting, the markets cheered the notion that interest rate hikes were over and the economy had not gone off the rails.

TWO YEARS OF TIGHTENING



SOURCE: YCHARTS

Earnings Recovery and Better Participation

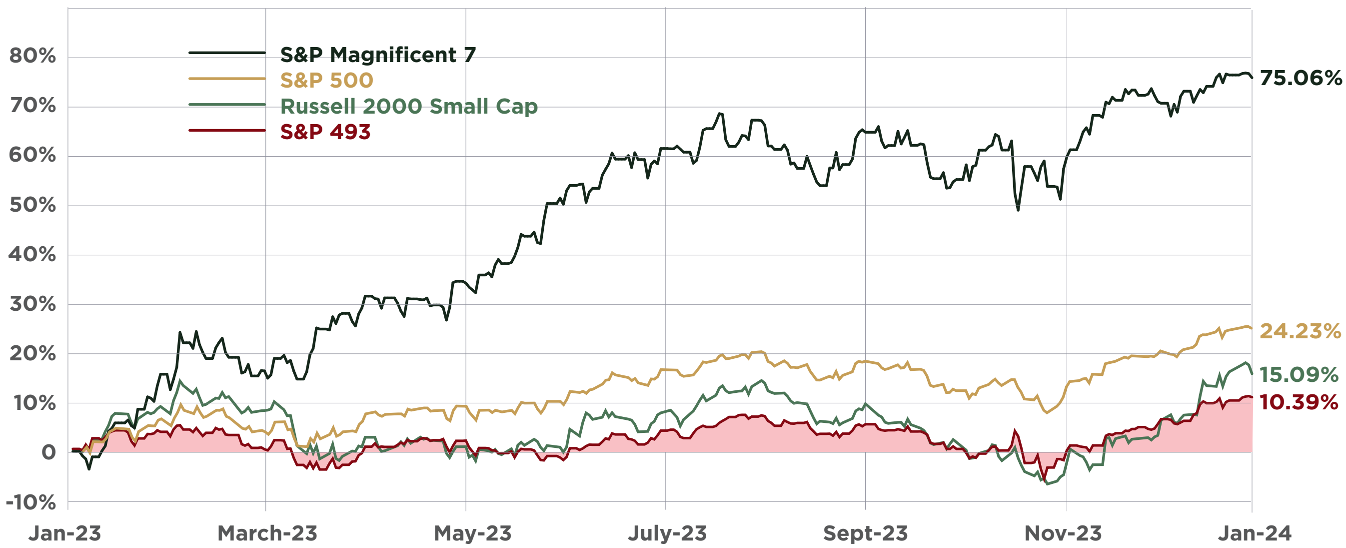
As Q4 progressed, corporate earnings surpassed expectations, effectively ending the 'earnings recession,' and stocks built momentum into the Dec. 13 Fed meeting, at which rates were once again left unchanged. Then Powell added more fuel to the rally when he unveiled the Committee's year-end 2024 median interest rate forecast of 4.6%, which suggested multiple rate cuts in the coming months. Sentiment soared, with investors finally seeing a light at the end of the tunnel.

The Q4 stock market rally was both impressive and notable for its improving breadth, with few stocks left behind. While the so-called 'Magnificent 7' continued to outpace the total S&P 500 index, the gap narrowed considerably. Furthermore, small-cap stocks – which have trailed large-cap stocks for 20+ years and trade at significantly far lower valuation multiples – joined the party, rising sharply and outpacing the S&P 500 index for the quarter. As we enter 2024, we are optimistic that market breadth will continue to improve and the extreme concentration of market returns will dissipate.

But perhaps the biggest shift in the markets last quarter was related to investor sentiment. We saw growing expectations for an economic "soft landing," with consumers and investors alike gaining confidence that a deep and damaging recession could be avoided.

Clearly, there are plenty of external issues to keep investors vigilant this year, ranging from the Presidential election to a dysfunctional Congress and rising geopolitical tensions. Still, the economy and markets' strength and resilience has been striking. A decade of low interest rates has lowered consumers and businesses debt levels, wages continue to rise, and the return of competitive bond yields has increased retirees' cash flow.

PRICE % CHANGE, 2023



SOURCE: YCHARTS

Wisdom Comes From Experience

Charlie Munger, Warren Buffett's long-time partner and confidant, who passed away in November, once said, "micro is what we do; macro is what we put up with." Similarly, the macroeconomic outlook is not central to our investment process here at HM Payson. Our priority is researching, purchasing, and holding high-quality companies with good characteristics. Munger and Buffett advocated buying "wonderful businesses at fair prices" – a mantra we frequently repeat.

Many HM Payson clients have been with the firm for several decades, during which we have weathered some extraordinary markets and economic events: the dot-com bubble, 9/11 and the war on terror, the global financial crisis and great recession, the COVID-19 pandemic, and more recently, the return of inflation and a bear market. Time and again, the economy and markets have proved resilient.

However, in our view, the government response to these episodes has gotten progressively more interventionist and extreme.

The rise of inflation was largely the result of extreme interest rate policy and massive government stimulus during the pandemic. Unwinding those policies and normalizing interest rates over the past two years has been arduous and painful. With the heavy lifting done, it is notable that the S&P 500 index on December 31, 2023 finished almost exactly where it began two years ago on December 31, 2021. The average Fed Funds rate since 1950 is 4.6%, and the current median Fed forecast for year-end 2024 is just that: 4.6%. We are optimistic that the economy can move forward without extraordinary policy measures, and our focus will remain on companies poised to drive long-term stock performance through innovation, entrepreneurship, and productivity.