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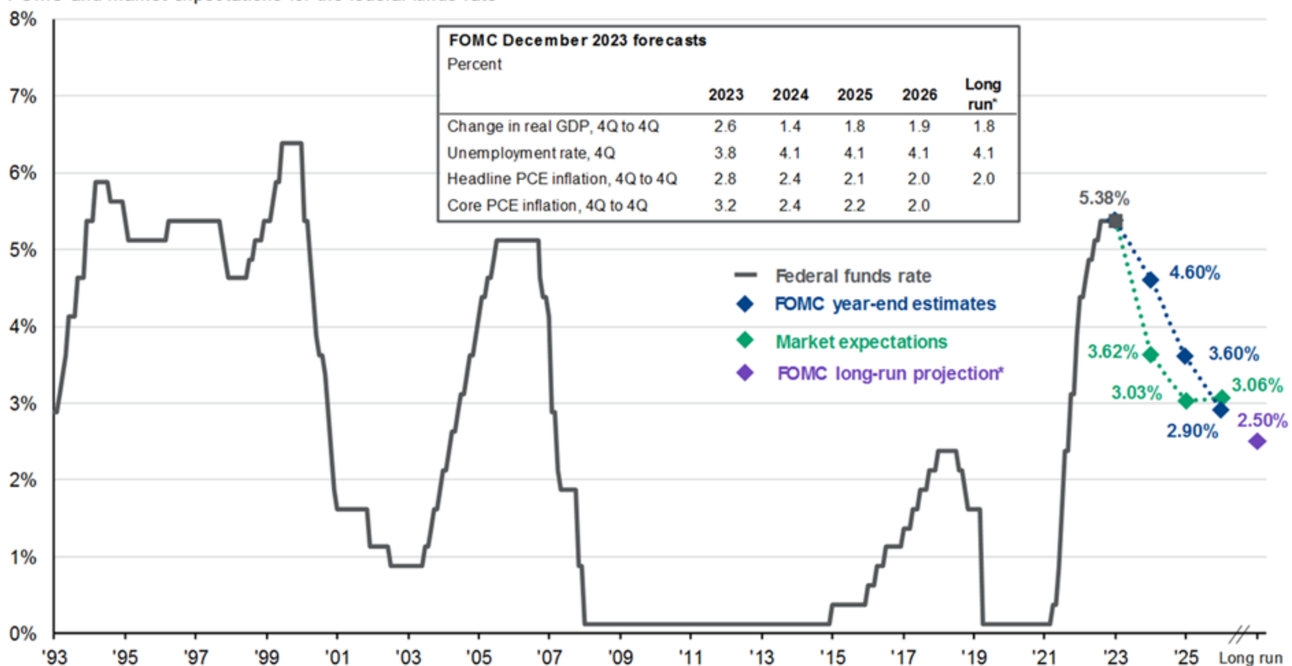
2023 Year End Review & Outlook

Where Are We Now - Part III? The Fed Has Pivoted Away from Raising Rates, What Now?

The economy and jobs market have held up better than anticipated and The Fed appears to be done raising interest rates. The question now is when do they begin cutting rates to complete the soft landing?

In its December meeting, the Federal Open Market Committee (FOMC) made a notable shift towards a more dovish stance, which was met with positive reactions from financial markets as the year came to a close. Having raised rates by 5.25% over the past two years to combat rising inflation, the FOMC is now indicating a willingness to thoroughly evaluate the broader macroeconomic landscape, including inflation and employment, when determining future interest rate policies. Presently, financial markets appear to be factoring in approximately 1.25% of easing, while the Federal Reserve's Summary of Economic Projections suggests around 0.75% of easing. Resolving this discrepancy in the upcoming months will be important for the markets, but it is unlikely to be the sole factor constraining gains in 2024.

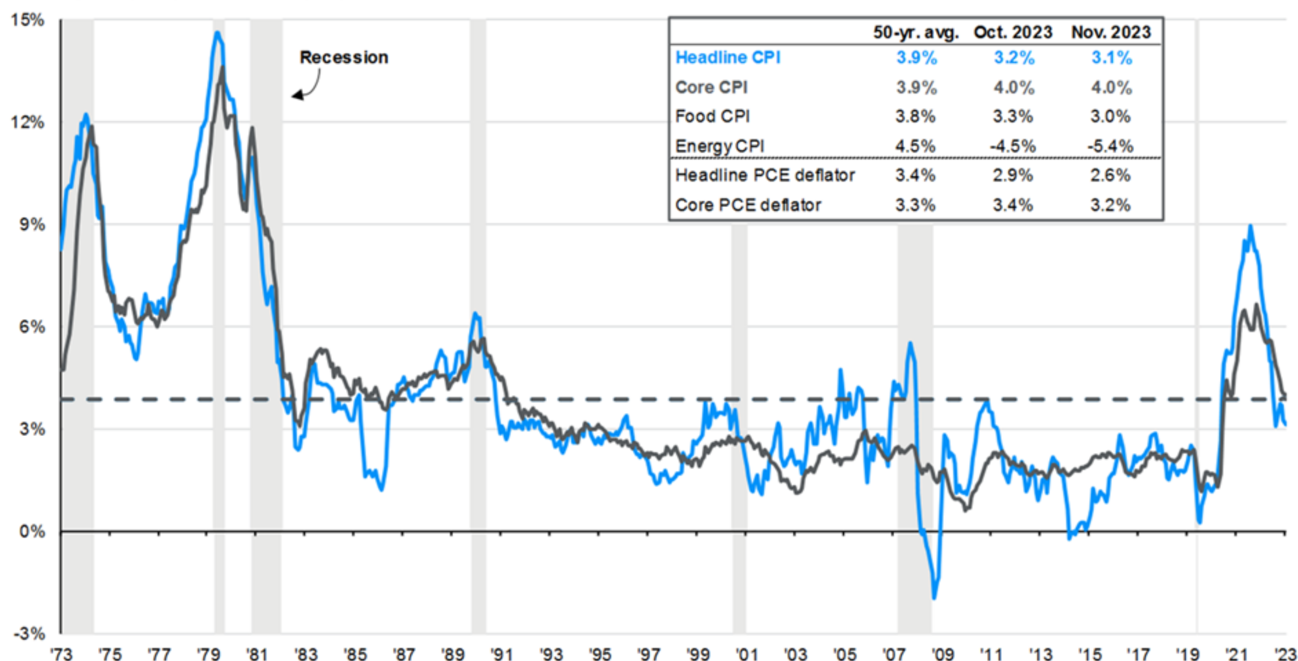


FOMC December 2023 forecasts
Percent

	2023	2024	2025	2026	Long run*
Change in real GDP, 4Q to 4Q	2.6	1.4	1.8	1.9	1.8
Unemployment rate, 4Q	3.8	4.1	4.1	4.1	4.1
Headline PCE inflation, 4Q to 4Q	2.8	2.4	2.1	2.0	2.0
Core PCE inflation, 4Q to 4Q	3.2	2.4	2.2	2.0	

Source: JP Morgan Guide to the Markets U.S. – 1Q 2024

With inflation expected to moderate and likely to fall within the range of 2% to 3% by mid-year, this development offers some support for the Federal Reserve. These inflation levels are considered manageable and fall within historical norms. Furthermore, we maintain the view that the sub-2% inflation levels experienced for much of the decade before COVID were excessively low and posed challenges to average hourly earnings and income for a significant portion of the workforce. A slightly higher inflation rate in the upcoming years should be welcomed, as it could potentially act as a safeguard against a slowdown in consumer spending.



	50-yr. avg.	Oct. 2023	Nov. 2023
Headline CPI	3.9%	3.2%	3.1%
Core CPI	3.9%	4.0%	4.0%
Food CPI	3.8%	3.3%	3.0%
Energy CPI	4.5%	-4.5%	-5.4%
Headline PCE deflator	3.4%	2.9%	2.6%
Core PCE deflator	3.3%	3.4%	3.2%

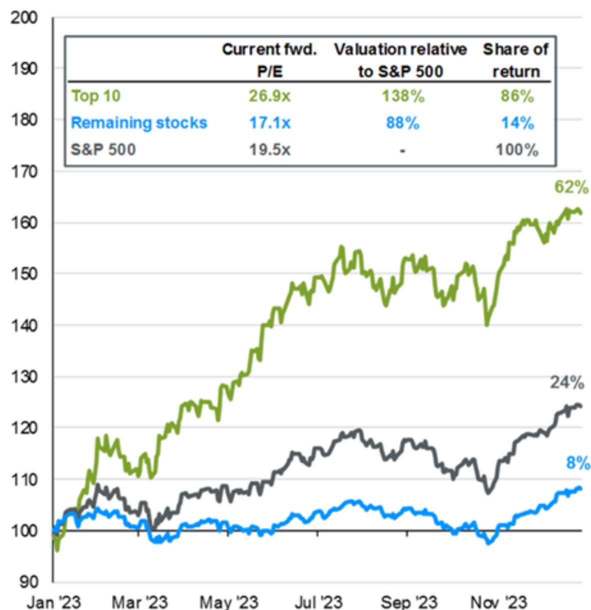
Source: JP Morgan Guide to the Markets U.S. – 1Q 2024

Decreasing yields are expected to have a positive impact on economic activity and various sectors within both equity and fixed income markets. Historically, lower yields have been advantageous for valuation, helping to lower interest expenses for companies, and offering consumers a boost when it comes to purchasing homes or financing substantial expenses. These are just a few of the potential advantages that the anticipated yield reversion in the coming year can offer to the broader economy, among other potential benefits.

Consensus earnings expectations are moderating and valuation levels in equities seem fair with opportunities in certain sectors.

Following a year in which many experts had predicted a recession, but earnings outperformed expectations, 2024 is expected to bring a significantly different outlook. Consensus earnings forecasts are currently adjusting slightly downward as the overall economy experiences a cooling trend. The fluctuations that characterized the latter part of 2023 have stabilized, setting the stage for a more achievable expectations scenario for this year. This scenario may support further upward momentum in equity prices as the year unfolds.

From a valuation perspective, domestic equities look fairly valued at current but an opportunity for a broadening in market participation should present itself sometime in the coming months. If we examine the S&P 500, it becomes evident that the top 10 stocks within the index are trading at higher multiples as compared to the broader index. Meanwhile, there is potential for growth in specific segments among the remaining 490 stocks that could drive the markets upward. From an earnings perspective, these 490 stocks have contributed 77% of the earnings over the past year while realizing just 66% of the weighting within the index. Mean reversion may reconcile this imbalance and offer more market breadth, which is generally a positive signal for equities.



Source: JP Morgan Guide to the Markets U.S. – 1Q 2024

We see opportunity in three key sectors in the coming year:

Industrials: The increasing integration of AI and technology is set to play a more significant role in this sector, potentially leading to substantial leveraged gains.

Utilities: Larger players who have made investments throughout the economic cycle are poised to reap substantial rewards on a larger scale. Falling yields are expected to act as a favorable tailwind, potentially offsetting some of last year's underperformance.

Health Care: Despite it being an election year, the sector has experienced broader underperformance, coupled with manageable growth expectations. This creates a favorable environment for above-market performance in 2024.

Additionally, we anticipate continued growth in the Technology and Communication Services sectors. However, selecting the right companies will become increasingly crucial in these two sectors, considering the significant outperformance they saw last year. Companies that can maintain superior top- and bottom-line growth compared to their peers are likely to be rewarded. Nevertheless, we expect there to be fewer such companies in comparison to 2023, when outperformance was more widespread in these sectors.

International equities offer an intriguing opportunity in terms of valuation, which is expected to become more favorable as the year progresses. Currently, there is a significant valuation gap compared to domestic equities, with international equities trading at roughly a 1/3 discount, in contrast to the approximately 16% average discount observed over the past 20 years. However, international equities are facing challenges such as a stronger U.S. dollar, higher inflation, and slower economic growth, which are expected to diminish as 2024 unfolds.

While our current portfolio strategies include exposure to international equities, we believe there may be an opportunity to modestly increase this exposure during 2024, aiming to capture a reversion to the mean that is likely to occur at some point.

Source: JP Morgan Guide to the Markets U.S. – 1Q 2024

Steepening of the yield curve and decreasing yields within the fixed income complex should materialize favorably in 2024. Nevertheless, we urge caution and prudent security selection going forward as interest rates decline and risks within the complex rise.

Considering anticipated declines in inflation and yields in 2024, the bond market appears to be positioned favorably from a risk-return perspective. Historically, owning bonds in a falling rate environment has allowed investors to capture attractive risk-adjusted returns as both the coupon and price appreciation drive outcomes. While this may be the case moving forward, selection is likely to play a larger role as broad market risks alternate between interest rate risk and economic risk. While volatility across the asset class should be lower in 2024, areas of concern remain that need to be viewed with caution – especially in a slowing macroeconomic environment.

In the fixed income markets, we see a favorable setup for interest rate-sensitive assets and those influenced by changes in the yield curve as it returns to a more typical shape. Consequently, we hold a preference for investment-grade securities, including Treasury, agency, and corporate bonds. These holdings are supplemented and diversified with high-yield bonds, Treasury Inflation-Protected Securities (TIPS), and adjustable-rate bonds, particularly those that are responsive to spread changes.

We continue to maintain a neutral stance regarding our allocation to equities, as we perceive the risk-reward balance to be generally favorable, although slightly less so due to the strong performance seen in 2023. In contrast, we hold a more positive outlook within the fixed income segment, as the overall setup appears increasingly advantageous; especially on a risk-adjusted basis.

The start of a Federal Reserve policy shift, unfolding throughout 2024, along with an uncertain yet improved global macroeconomic environment, creates a backdrop that suggests a potential return to normalization across multiple asset classes.

In the equity markets, the trend of growth outperforming value persisted. However, we anticipate an opportunity for the equity markets to diversify and broaden their performance during 2024, which we consider a positive development. Our portfolio strategies incorporate both growth and value attributes, and as a result, we avoid extreme tilts in our active strategies. Instead, we aim to strike a balance by positioning ourselves in the "core" and seek to outperform through meticulous stock selection.

Consequently, we believe that the equity markets, both domestic and international, are transitioning into a market where individual stock selection will play a more significant role. This effect is expected to be more pronounced in the U.S., and somewhat less so in foreign markets, where valuations are lower, and assets may move more cohesively.

Likewise, the recent repricing within the fixed income space has unveiled opportunities, particularly in the medium and long-term segments of the Treasury curve, in municipal bonds where state and local budgets are generally healthy, in high-yield bonds where the expected widening of spreads due to higher defaults has yet to materialize significantly, and in specific segments of investment-grade bonds where the risk-reward ratio appears favorable.

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