4Q 2023
Market Commentary

The markets ranged to and fro over the 2022-2023 period. Well, that perspective might be a bit understated given the massive amount of up and down volatility over the last two years. The shock to valuations in 2022, in part, created some of the opportunity in 2023. Here are a few examples. The NASDAQ, S&P 500 and Russell 1000 Value gained roughly 43%, 26%, and 11%, respectively, in 2023. Wow, what a spread! The last time the NASDAQ had a year this stellar was 2003, 20 years ago. 2023 wasn't a routine year or necessarily a precursor of future events. Of course, 2022 was the opposite extreme. These three indexes fell -33%, -18%, and -7.5% in that year. Compound the two years and you get "much ado about nothing." Over the two-year period, the NASDAQ still produced a negative -4% total return! The S&P 500 and the Russell 1000 Value each gained a bit over 3%, most of which came from dividend income. Even today's Magnificent Seven (Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia, and Tesla), which plunged an average 40% in 2022 and surged 77% in 2023, compounded at a total return of only about 6% over the two-year period.

Might earning positive returns in each of the last two years be a less rattling outcome to one's financial health?

Investors weren't saved by fixed income returns either over the last two years. Bloomberg's Long-Term Treasury index plunged -29% in 2022, nearly as bad as the NASDAQ. Despite the massive rally in the 4th quarter of 2023, the two-year total returns were roughly -8% and -26%, respectively, for the Bloomberg Government/Credit and Long-Term Treasury indexes. No saving grace here.

What created such overall volatility in returns and will future years be any different?

By the end of 2021, a decade of ZIRP (Zero Interest Rate Policy) by the Federal Reserve pushed up Price/Earnings ratios on the market to highs not seen since the late 1990s. We frequently opined in newsletters and quarterly reports the damage ZIRP created for the economy hooked on low-cost credit. At the same time, the acceleration of revenue growth for tech and media stocks during the pandemic came to an end in 2022, with disappointing results that created the plunge in the NASDAQ and S&P 500. The rebound in 2023, however, has recreated much of the overvaluation that existed at the end of 2021.

Using the 10-year Treasury bond yield as a proxy for the fixed income market, its yield was 1.5% at the end of 2021 and surged to 4.9% in late October of 2023 for a greater than 200% increase, only to fall back to 3.8% for a 25% or so decrease by the end of 2023. Irrespective of whether the yield remains near 4% or rises back to 5%, Treasury and credit markets have essentially returned to more "normal" levels from artificially low levels. Default rates on corporate bonds with low credit ratings are also headed higher to a more "normal" level. Although the full pain of these changes was felt in a few bank failures early in 2023, it hasn't yet resulted in significant slowing real economic growth or recession. Nevertheless, bond market yields are essentially back to the levels they should be at for markets to properly price credit risks.

As for the equity markets, in April of 2023, Nvidia announced that its AI chip would generate $4 billion more in 2nd quarter sales than it had previously estimated. This immediately generated the craze for investing in any stock that even remotely might be involved in artificial intelligence. The vast majority of the NASDAQ's 2023 return came in the 1st half with a return of 32% as investors raced to buy these stocks. It doesn't appear to us that this roller coaster ride will end in 2024. AI appears to be a great tool for improving productivity in the economy, but then so did the internet's emergence in the late 1990s. It took three years (2000-2002) to wipe out the overvaluation of that period.

Price inflation has peaked, and this is a positive for overall markets and the real economy. The headline CPI change year-to-year dropped from 9% in June of 2022 to 3% in November of 2023. The path to the Fed's 2% price inflation target seems possible if unlikely in the next two years. Fed Chair Powell, however, added fuel to this fire by recently suggesting further rate increases were no longer on the table. The rally in bond prices (fall in yields) in the 4th quarter already discounts the expectation of three to six Fed Funds Rate cuts (of 25 basis points each) in 2024. While some rate cuts may occur, the absence of significant cuts in 2024 would now be a big disappointment for both stock and bond markets.

So we're not convinced the roller coaster ride in the overall markets is done. Massive deficit spending by the federal government continues to support the real economy and at the same time, massive issuance of Treasury notes and bonds to fund these deficits may put a halt to today's bond and stock market optimism. Add to this a contentious presidential election cycle, another federal budget battle, rising world geopolitical tensions between the U.S. and China and between Israel and Iran's proxies, along with the no-end-in-sight war between Ukraine and Russia, and we believe playing defense is better than playing offense in 2024.