

ECONOMIC OUTLOOK

Summary

The New Year's festivities may be over, but the economy is still celebrating a stronger than expected end to 2023. A solid labor force and strong consumer demand continues to drive the economic momentum we have seen all year, and because of that it's a real possibility full year GDP could come close to 3.0%.

The Atlanta Fed's GDPNow model began the month of December projecting roughly 1.2% growth for the fourth quarter, which would have translated into the weakest quarter of the year. But since then, their projections have soared to more than 2.5%, partly because the labor market and consumer spending have been more resilient than anticipated. The unemployment rate unexpectedly slid back down to 3.7% for two consecutive months, while weekly initial jobless claims remained at reasonable levels. Job Openings and Labor Turnover Survey (JOLTS) data continued to decline, shrinking the gap between those looking for work and job openings. In addition, average hourly earnings remain above expectations at 4.1% year-over-year and are still elevated compared to pre-COVID levels. There is an expectation that as long as most Americans are employed, they will continue to spend money. We saw that play out in the December release for retail sales, which was expected to decline yet still managed 0.4% growth. Durable goods orders were also more than 3.0% higher than expected for the month, all while we saw inflation continue to abate.

Coming into 2023, there was a consensus expectation among market participants for an economic slowdown due to higher rates. Fortunately, that never came to fruition. Still, monetary policy is known to work with long and variable lags, and this rate-hiking cycle has yet to bite the overall economy in a significant way.

With nearly six rate cuts now priced into the markets and financial conditions easing significantly, odds are increasing the Fed might actually thread the needle and orchestrate an economic soft landing. However, we still can't rule out a delayed negative impact from higher rates or the possibility that continued above-trend growth and demand could lead to another wave of inflation.

Positives

December non-farm payrolls beat expectations by 41k (216k vs. 175k est.)

Core PCE, the Fed's preferred measure of inflation, declined by 0.3% to 3.2%

University of Michigan consumer sentiment increased substantially in December (69.7)

Negatives

Final GDP for the third quarter was revised down 0.3% (4.9% vs. 5.2% est.)

The labor force participation rate declined to 62.5%, its lowest value in 10 months

ISM manufacturing remains in contractionary territory for the 14th straight month (47.4)

EQUITY OUTLOOK

Summary

Equity markets closed the year on a high note with the S&P 500 adding another 4.5% in December to what was already a very impressive year. The index finished the year up 26.3% and within spitting distance of all-time highs. The market's gains in 2023 essentially wiped out the extraordinary losses of 2022.

Widening market participation, or breadth, also improved further in December. While value stocks still trailed growth stocks significantly for the year, the Russell 1000 Value Index rose 5.5% versus the 4.4% gain in the Russell 1000 Growth Index in December. More dramatically, the Russell Midcap and small-cap Russell 2000 Index soared 7.7% and 12.2% respectively. The continuing improvement in breadth is widely considered to be a positive sign for the equity market moving forward.

As we move into 2024 there are many reasons to be optimistic. Inflation continues to trend lower and the Federal Reserve is expected to shift to a more accommodative policy. U.S. households are generally in good shape and there is plenty of liquidity to eventually be invested. Many corporate balance sheets are very strong with sufficient cash flow to finance growth internally.

One of the biggest concerns for equity investors is the failure of Congress to make long-term progress on addressing the federal budget deficit. This issue will have to be dealt with in the coming weeks and will likely have some impact on capital markets. Challenges created by potential fiscal austerity measures are not supportive of current equity valuation levels.

However, dramatically improving worker productivity caused by a wave of technology advances (automation and machine learning) could boost GDP and allow us to escape our debt situation with less pain.

While we are generally optimistic, 2023 was such a strong year, it is unlikely stocks will move higher in a linear fashion. In a highly contentious presidential election year, there are bound to be some bumps and bruises along the way. Still, we enter 2024 with far more visibility than in recent years. Happy New Year!

Positives

Federal Reserve becoming more accommodative

Improved economic visibility

Technology advancing worker productivity

Negatives

Congressional budget fight

Geopolitical uncertainty

Recession still a possibility

FIXED INCOME OUTLOOK

Summary

The “everything rally” of November continued in December with the Fed pivoting at their mid-month Federal Reserve’s Open Market Committee (FOMC) meeting. Following another month of favorable inflation data, they were no longer pondering the extent to which further tightening would be necessary, but rather they began discussing when lowering the overnight rate would be appropriate. The individual participants’ expectations for rate cuts in 2024 increased from a consensus of one to three. They also added one more cut to their consensus for 2025. Yields dropped across the curve. The 2-year ended 43 basis points (bps) lower at 4.24% while the yield on the 10-year declined from 4.33% to 3.88%. This year-end level is ironically exactly where it started the year after being as low as 3.30% in April and as high as 5.00% in October. The 30-year Treasury bond yield declined by 47 bps to 4.03%. With risk markets zooming, investment-grade credit spreads narrowed another 5 bps. They are now about 17 bps tighter than their 3-year average. Financial company bonds outperformed those of industrial issuers. Out of the 575 observations since its inception, the Bloomberg Aggregate Index experienced its 15th best monthly return in December. Combined with November, it was the seventh best 2-month period return ever.

After the fastest rate-hiking cycle in history, there is near a universal belief the Fed is finished. Chairman Powell even suggested such at the conclusion of December’s FOMC. The question now is the timing and magnitude of future rate cuts. Some are suggesting cuts will begin as soon as February, while others, including some of the FOMC participants, are suggesting it is more likely to commence in later 2024. As of year’s end, the Fed Funds futures market was pricing for six rate cuts starting in March. We are more inclined to believe that Fed’s expectations of three rate cuts might be more probable than six. A part of our outlook is based on our increasing confidence a soft landing can actually be achieved.

Yields could retrace some of the recent moves if a few of the rate cuts are taken out of the market’s expectations. On the other hand, if the labor market deteriorates more rapidly or to a greater magnitude than we expect, even the market’s forecast might not be enough. We recommend maintaining durations near that of the benchmark and using back-ups in yield to adjust portfolios from the effects of aging. While we gradually upgraded quality within all of the strategies throughout 2023, our blended strategies continued to hold a higher exposure to corporate bonds.

Positives

The Fed Funds rate-hiking cycle appears over. Rate cuts should commence in 2024

Expectation for a reduction in net new corporate issuance in 2024

Reallocation from riskier asset classes could occur given the strong equity market returns

Negatives

Federal budget deficit unlikely to improve during an election year

U.S. investment-grade credit spreads now less than 3-year average

Unknowns

Global trade with rising shipping costs

Russia/Ukraine war. Israel/Hamas war