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"The Big Pivot"

Dear Clients and Friends: January 15, 2024

Last year at this time, 85% of economists in one poll predicted a recession was coming in 2023. They were worried about the interest rate hiking cycle the Federal Reserve had embarked on to cool inflation by slowing the economy. This was a relatively optimistic take compared to the 100% probability they forecasted just two months earlier. Compounding concerns, Federal Reserve Chair Jerome Powell was expressing fear that those same necessary interest rate hikes would likely cost the American economy millions of jobs. Things were looking pretty dire.

Given the consequences, markets became obsessed with the Fed's outlook on inflation and their handling of interest rates. Both stock and bond prices oscillated widely throughout the year. When economic data emerged showing slowing inflation, markets would rally with the assumption that the Fed would pivot on its interest rate stance. The Fed would then issue language reminding everyone that the plan was still "higher for longer," causing markets to sell off in disappointment. The next data point would emerge starting the roller coaster ride all over again.

Heading into November, the average stock in the S&P 500 was down -4% and the bond market was staring at a third consecutive year of negative returns. Then, a good inflation number came out… and the Fed pivoted. It was a big pivot too. This time they did not push back against the market's assumptions. Some argued they even fed into them. Mind you, the Fed did not start cutting rates; they just suggested an end to the hiking. Equity and fixed income markets around the world rejoiced.

Many have called the fourth quarter the "everything rally." Up until then, most of the stock market's performance for the year had been heavily concentrated in the Magnificent 7 and the Artificial Intelligence (AI) trade. After the Fed pivoted, almost everything moved up. Major indices rallied 10% to 15% during the quarter, saving portfolios from a year of middling to negative returns. The S&P 500 finished the year up 26% with smaller and international stocks up around 16%. The equally weighted index that we have been writing about in recent quarters rallied from flat to up just under 14%. While performance was good, it was still a very narrow market. For the year, a record 72% of the individual stocks in the S&P 500 underperformed the broader index's return.

As the idea of a soft landing in 2024 became more realistic, the bond market began to aggressively price in rate cuts that it felt the Fed would eventually implement. Yields quickly moved lower for most parts of the yield curve, excluding the very short end. By December, six rate cuts were expected in the coming year, twice as many as the Fed's stated view of only three. Prior to the pivot, the 10-year Treasury yield peaked at 4.99%. The rally in yields, in accordance with this mindset, left the 10-year yield over one percent lower, at 3.88%. Lower yields translate into higher bond prices. Year to date returns for the aggregate bond market went from negative territory to a gain of 5.5%. The November return alone of 4.5% was the largest monthly gain since May of 1985.

Why No Recession?
The economists' concerns of recession and job losses never materialized in 2023. Inflation and unemployment proceeded in the right direction. Not only was a recession avoided, but the U.S. recorded solid economic growth for the year. Even more extraordinary, conditions continued to improve throughout the still ongoing post pandemic business disruptions, the Ukraine/Russian war, a mini banking crisis, threats of government shutdowns, three more interest rate hikes, and an attack on Israel. Remarkable.

Avoiding recession was not just luck, various real factors were at play. The 2023 economic story will be remembered as one of a resilient consumer as people opened their wallets more than expected. Americans entered the year with a stockpile of cash left over from the pandemic and apparently had no problems spending it. While the amount of excess savings has dwindled, collectively, hundreds of billions still remain. Additionally, with inflation coming down but wage increases continuing, "real" income is now positive again. This makes continuing current spending habits more likely.

Most households and businesses were also more insulated from interest rate increases than expected. This time around, both had locked in already low interest rates prior to the hefty increases that began in March 2022. For example, data shows that while mortgage rates have moved back over 7%, the average American's mortgage is still below 4%. The Fed's telegraphing of their hikes, plus the persistent recession calls, prompted consumers and businesses to prepare for a surge in the cost of borrowing.

Lastly, a much anticipated weakening in the labor market never arrived. The rate of unemployment hovered around a record low 3.7% all year. Over the last twelve months, the U.S. added 2.7 million new jobs and saw the labor force participation rate progress back to pre-pandemic levels. Those looking for any real weaknesses on this front see it in a cooling of the number of job openings (JOLTS data). However, the Fed points to this data to show the competition for workers has diminished somewhat and is limiting wage inflation.

The Fed and Their Work
Unfortunately, so much of the markets' performance, and our commentary for that matter, seems to be focused on the Fed and their interest rate outlook. Interest rates are a key factor in the economy, especially in times of pivots. They affect the cost of borrowing money, which in turn can impact consumer spending and business investment. When rates are low, borrowing money is cheaper, encouraging spending and investment, and therefore growth in the economy. Conversely, when rates are high, borrowing money becomes more expensive, which can slow down spending and investment, therefore dampening growth and sometimes causing a recession.

But what are high and low? High and low rates are not necessarily discrete, identifiable numbers, but instead, usually levels comparative to the intermediate and long-term expectations for inflation. It is the relative difference between the level of rates and the level of inflation that is so important. So, when the Fed sets rate levels below inflation expectations, they are actively promoting growth in the economy. Wall Street likes to call this "accommodative." This was mostly their stance after the Financial Crisis and throughout COVID.

When the Fed sets rates above inflation expectations, they are actively trying to slow the economy, usually to dampen growth, remove excess demand, and therefore bring down inflation. Wall Street calls this stance "restrictive." How accommodative or restrictive they are is determined by just how much above or below the expected inflation level they hold rates.

How does this relate to the current environment? The Fed has presently set their rate at 5.25%, well above their target goal of inflation of 2.0%. They have been restrictive on purpose while recent inflation has been elevated and well above their target. However, as inflation comes down, if they hold rates steady, by definition, they become more and more restrictive. This increases the chance of recession and diminishes the hopes of a soft landing. Therefore, they must start to reduce rates soon, just to remain neutral in the amount of brakes they are applying to the economy. This is where we find ourselves today and all the excitement about the Fed's Big Pivot.

Outlook

Pros spend a lot of time thinking about potential risks. At the beginning of 2023, it seemed like strategists and economics were dwelling on the downside, maybe too much. Most ended up being too pessimistic about the outlook.

Perhaps it is more constructive to make observations instead of forecasts. To be sure, things look better. 2023 proved that it is possible to have an economy running at full employment, see good economic growth, and still bring inflation back down toward the 2% target. Fed trajectory is also much more certain which should provide a bullish tailwind for 2024. However, the everything rally of the fourth quarter priced a lot of optimism into markets and may have made investors a bit too confident.

There are still more than a handful of risks for which we need to be aware. The easy work on inflation has been done. The move from 9% to the current 3.5% was on the back of cleaning up pandemic messes. The remaining inflation embedded in the system could be much more sticky. Slowing inflation is good for consumers, but can reduce pricing power, margin growth and earnings for companies. Speaking of earnings, many of the exciting investment themes from last year (think AI and obesity drugs) will require companies to show proof that these investments can turn into earnings. Other concerns include Ukraine still not being settled and the growing risk that the conflict in Israel spreads.

Higher interest rates have also revived talks about the growing interest expense associated with the accumulated $30 trillion federal debt, not to mention the ongoing annual deficits that continue to add to that debt. There are two scheduled government shutdowns in the next month, both with this issue at the center. Oh… and there is an election this year. Ugh.

2023 was a year of unpredictability and 2024 should be no different. If you squint real hard though, data shows most things moving back to normal. Normal would be nice.

Thank you again for your continued confidence and trust as we work through these extraordinary times. We welcome your comments, questions, and referrals. Please don't hesitate to contact us. Please stay safe and well.

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