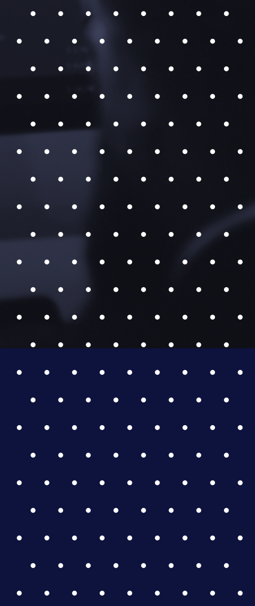


Stocks Rebound and Post Best Return Since 2021

By Matthew Gaude & Shawn McGuire

How Do You Sum Up 2023?

Markets staged an impressive reversal in the fourth quarter thanks to a surprise bullish pivot by the Federal Reserve, which combined with solid economic activity and declining inflation to push stocks sharply higher and send the S&P 500 to two-plus-year highs, resulting in the best annual return since 2021.

The strong fourth-quarter performance somewhat obscures the fact that stocks and bonds started the fourth quarter under significant pressure. First, Treasury yields continued to move higher in early October, which weighed on stocks and bonds, just like in the third quarter. Then on October 7th, Hamas soldiers infiltrated settlements in Israel, killing and kidnapping more than 1,200 Israelis in the worst attack on Israel in decades. The market fallout was immediate, as oil prices spiked amid fears a broader regional war would ensue between Israel, Hamas, Lebanon, and potentially Iran. Higher oil prices fueled a further increase in Treasury yields as investors priced in a possible oil-driven bounce back in inflation. Those factors, combined with a lackluster earnings season, resulted in the S&P 500 falling to the lowest levels since mid-May while the 10-year Treasury yield touched 5.00% for the first time since the mid-2000s.

However, markets reversed when Fed Governor Chris Waller made comments that implied rate hikes were over and rate cuts may be coming in 2024. The market reaction was immediately positive as stocks and bonds rallied hard into month-end to finish well off the lows and with just a 2% decline.

That positive momentum continued in November as the S&P 500 posted its best monthly return of 2023, rising more than 9%. There were several factors that fueled this rally. First, numerous Fed officials echoed Waller's commentary, and investors priced in rate cuts as early as May, substantially earlier than previously expected. Additionally, the Israel-Hamas conflict did not spread and remained contained between Israel and Hamas, and oil prices declined as a result, easing inflation concerns. Finally, inflation metrics continued to decline. The year-over-year increase in the Consumer Price Index dropped to 3.14%, which further fueled investor expectations that rate cuts would come in the first half of 2024. Those factors combined with generally favorable seasonality to fuel a welcomed "Santa Claus Rally."

The Santa rally continued and accelerated in December courtesy of the Fed. At the December 13th FOMC meeting, Fed officials clearly signaled that rate hikes were over and forecasted three rate cuts in 2024, one more than previously forecasted. Additionally, Fed Chair Powell did little to push back against the markets' expectations for rate cuts. Put plainly, the Fed surprisingly pivoted to a more dovish policy stance, and that fueled a continuation of the rally that started in late October. The S&P 500 rose to the highest level since January 2022 while the Dow Industrials hit a new all-time high.

In sum, 2023 was a year of surprises for the markets as the expectations for a recession never materialized, inflation fell faster than forecasts, corporate earnings proved resilient, and the Fed surprised markets by pivoting to a more dovish future policy. The result was substantial gains for the major averages.

Q4 and Full-Year 2023 Performance Review

Stocks enjoyed a broad and powerful rally in the fourth quarter as all four major U.S. stock indices posted strong quarterly gains. Investor expectations for rate cuts in 2024 were a major influence on markets in the fourth quarter as the Russell 2000 and Nasdaq 100 outperformed the S&P 500 over the past three months; companies in those two indices are expected to benefit most from a sustainable decline in interest rates. For the full year, however, the dual influences of 1) artificial intelligence (AI) enthusiasm and 2) rate cut expectations drove performance as the tech-heavy Nasdaq 100 massively outperformed the other major stock indices, surging more than 50%. The S&P 500 also logged a substantial gain of over 20% thanks mostly to the large weighting of technology stocks in the index. The less-tech-stock-sensitive Dow Industrials and Russell 2000 also enjoyed strong returns in 2023, but relatively underperformed the Nasdaq and S&P 500. Notably, the index performance for the full year 2023 was the opposite of 2022, where we saw the Nasdaq and small caps decline substantially more than the S&P 500 and Dow Jones Industrial Average.

Stock Index Performance

Index	Week	YTD	12-mo.	2023	5-yr.
Dow Jones Industrial Avg. (37,690)	0.81%	16.18%	16.18%	16.18%	12.72%
S&P 500 (4,770)	0.34%	26.26%	26.26%	26.26%	15.85%
NASDAQ 100 (16,826)	0.30%	55.13%	55.13%	55.13%	22.81%
S&P 500 Growth	0.09%	30.02%	30.02%	30.02%	16.42%
S&P 500 Value	0.63%	22.19%	22.19%	22.19%	14.24%
S&P MidCap 400 Growth	-0.22%	17.44%	17.44%	17.44%	12.13%
S&P MidCap 400 Value	-0.06%	15.35%	15.35%	15.35%	13.04%
S&P SmallCap 600 Growth	-0.18%	16.93%	16.93%	16.93%	10.48%
S&P SmallCap 600 Value	0.13%	14.84%	14.84%	14.84%	11.34%
Russell 2000	-0.26%	16.88%	16.88%	16.88%	10.10%
MSCI EAFE	1.16%	18.24%	18.24%	18.24%	8.26%
MSCI World (ex US)	1.74%	15.62%	15.62%	15.62%	7.17%
MSCI World	0.57%	23.79%	23.79%	23.79%	12.96%
MSCI Emerging Markets	3.24%	9.83%	9.83%	9.83%	3.75%
S&P GSCI	-1.39%	-4.27%	-4.27%	-4.27%	8.68%

Source: Bloomberg. Returns are total returns. *5-yr. return is an average annual.*
One-week, YTD, 12-mo. and 5-yr. performance returns calculated through 12/29/23.
An index cannot be purchased directly by investors. Past performance is no guarantee of future results.

By market capitalization, small caps outperformed large caps in the fourth quarter thanks to those surging rate cut expectations, as lower rates are typically most beneficial for smaller companies. For the full year, however, large caps handily outperformed small caps thanks to the strength in large-cap tech stocks and as the higher rates in the first three quarters of 2023 weighed on small cap performance earlier in the year.

From an investment-style standpoint, growth significantly outperformed value both in the fourth quarter and for the full year. The reasons were familiar ones: artificial intelligence enthusiasm powered tech-heavy growth funds early in 2023, while in the fourth quarter expectations for rate cuts were seen as positive for growth stocks. Growth outperforming value is also the opposite of 2022, where higher rates and recession fears resulted in value outperforming growth.

Following is a chart with asset class total returns going back to 2011. In 2023, we saw a reversal in performance for each asset class (except for cash).

CREATIVE PLANNING		Asset Class Total Returns Since 2011 (Data via YCharts as of 12/31/23)													@CharlieBilello	
ETF	Asset Class	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2011-23 Cumulative	2011-23 Annualized
N/A	Bitcoin ($BTC)	1473%	186%	5507%	-58%	35%	125%	1331%	-73%	95%	301%	66%	-65.5%	**155.8%**	14093099%	148.9%
QQQ	US Nasdaq 100	3.4%	18.1%	36.6%	19.2%	9.5%	7.1%	32.7%	-0.1%	39.0%	48.6%	27.4%	-32.6%	**54.9%**	748.5%	17.9%
IWF	US Growth	2.3%	15.2%	33.1%	12.8%	5.5%	7.0%	30.0%	-1.7%	35.9%	38.3%	27.4%	-29.3%	**42.6%**	516.2%	15.0%
SPY	US Large Caps	1.9%	16.0%	32.2%	13.5%	1.2%	12.0%	21.7%	-4.5%	31.2%	18.4%	28.7%	-18.2%	**26.2%**	382.3%	12.9%
EFA	EAFE Stocks	-12.2%	18.8%	21.4%	-6.2%	-1.0%	1.4%	25.1%	-13.8%	22.0%	7.6%	11.5%	-14.4%	**18.4%**	90.6%	5.1%
IWM	US Small Caps	-4.4%	16.7%	38.7%	5.0%	-4.5%	21.6%	14.6%	-11.1%	25.4%	20.0%	14.5%	-20.5%	**16.8%**	207.9%	9.0%
MDY	US Mid Caps	-2.1%	17.8%	33.1%	9.4%	-2.5%	20.5%	15.9%	-11.3%	25.8%	13.5%	24.5%	-13.3%	**16.1%**	262.9%	10.4%
CWB	Convertible Bonds	-7.7%	15.9%	20.5%	7.7%	-0.8%	10.6%	15.7%	-2.0%	22.4%	53.4%	2.2%	-20.8%	**14.5%**	200.5%	8.8%
GLD	Gold	9.6%	6.6%	-28.3%	-2.2%	-10.7%	8.0%	12.8%	-1.9%	17.9%	24.8%	-4.2%	-0.8%	**12.7%**	37.8%	2.5%
VNQ	US REITs	8.6%	17.6%	2.3%	30.4%	2.4%	8.6%	4.9%	-6.0%	28.9%	-4.7%	40.5%	-26.2%	**11.8%**	166.1%	7.8%
HYG	High Yield Bonds	6.8%	11.7%	5.8%	1.9%	-5.0%	13.4%	6.1%	-2.0%	14.1%	4.5%	3.8%	-11.0%	**11.5%**	76.6%	4.5%
IWD	US Value	0.1%	17.5%	32.1%	13.2%	-4.0%	17.3%	13.5%	-8.5%	26.1%	2.7%	25.0%	-7.7%	**11.4%**	242.0%	9.9%
EMB	EM Bonds (USD)	7.7%	16.9%	-7.8%	6.1%	1.0%	9.3%	10.3%	-5.5%	15.5%	5.4%	-2.2%	-18.6%	**10.6%**	51.7%	3.3%
LQD	Investment Grade Bonds	9.7%	10.6%	-2.0%	8.2%	-1.3%	6.2%	7.1%	-3.8%	17.4%	11.0%	-1.8%	-17.9%	**9.4%**	59.5%	3.7%
PFF	Preferred Stocks	-2.0%	17.8%	-1.0%	14.1%	4.3%	1.3%	8.1%	-4.7%	15.9%	7.9%	7.2%	-18.2%	**9.2%**	69.9%	4.2%
EEM	EM Stocks	-18.8%	19.1%	-3.7%	-3.9%	-16.2%	10.9%	37.3%	-15.3%	18.2%	17.0%	-3.6%	-20.6%	**9.0%**	11.7%	0.9%
BND	US Total Bond Market	7.7%	3.9%	-2.1%	5.8%	0.6%	2.5%	3.6%	-0.1%	8.8%	7.7%	-1.9%	-13.1%	**5.7%**	30.5%	2.1%
BIL	US Cash	0.0%	0.0%	-0.1%	-0.1%	-0.1%	0.1%	0.7%	1.7%	2.2%	0.4%	-0.1%	1.4%	**4.9%**	11.4%	0.8%
TIP	TIPS	13.3%	6.4%	-8.5%	3.6%	-1.8%	4.7%	2.9%	-1.4%	8.3%	10.8%	5.7%	-12.2%	**3.8%**	37.9%	2.5%
TLT	Long Duration Treasuries	34.0%	2.6%	-13.4%	27.3%	-1.8%	1.2%	9.2%	-1.6%	14.1%	18.2%	-4.6%	-31.2%	**2.8%**	47.1%	3.0%
DBC	Commodities	-2.6%	3.5%	-7.6%	-28.1%	-27.6%	18.6%	4.9%	-11.6%	11.8%	-7.8%	41.4%	19.3%	**-6.2%**	-13.1%	-1.1%
Highest Return		BTC	BTC	BTC	VNQ	BTC	BTC	BTC	BIL	BTC	BTC	BTC	DBC	BTC	BTC	BTC
Lowest Return		EEM	BIL	GLD	BTC	DBC	BIL	BIL	BTC	BIL	DBC	TLT	BTC	DBC	DBC	DBC
% of Asset Classes Positive		62%	95%	52%	71%	38%	100%	100%	5%	100%	90%	67%	10%	95%	95%	95%

On a sector level, 10 of the 11 S&P 500 sectors finished the fourth quarter with a positive return, while 8 of the 11 sectors ended 2023 with gains. Not surprisingly, the dual influences of artificial intelligence enthusiasm and expectations for rate cuts drove sector trading in the fourth quarter and throughout the year. In the fourth quarter, the influence of expected lower rates was dominant as REITs were the best-performing sector, followed by tech. Both stand to benefit from falling interest rates. Cyclical sectors also outperformed over the past three months as expectations for stable economic growth rose with the Fed telegraphing future rate cuts. For the full year, however, the influence of AI enthusiasm was clearly the dominant influence on sector trading, as the three most "AI-sensitive" sectors (tech, consumer discretionary, and communications services) massively outperformed the remaining eight S&P 500 sectors.

S&P Sector Performance					
Index	Week	YTD	12-mo.	2023	5-yr.
Communication Services	-0.40%	55.80%	55.80%	55.80%	13.36%
Consumer Discretionary	-0.43%	42.30%	42.30%	42.30%	13.95%
Consumer Staples	1.11%	0.52%	0.52%	0.52%	10.94%
Energy	-1.37%	-1.42%	-1.42%	-1.42%	13.39%
Financials	0.74%	12.10%	12.10%	12.10%	12.11%
Health Care	0.97%	2.06%	2.06%	2.06%	11.88%
Industrials	0.74%	18.08%	18.08%	18.08%	14.39%
Information Technology	0.27%	57.84%	57.84%	57.84%	27.15%
Materials	-0.07%	12.55%	12.55%	12.55%	13.75%
Real Estate	0.84%	12.27%	12.27%	12.27%	8.88%
Utilities	1.21%	-7.08%	-7.08%	-7.08%	7.15%

Source: Bloomberg. Returns are total returns. *5-yr. return is an average annual.* One-week, YTD, 12-mo. and 5-yr. performance returns calculated through 12/29/23. An index cannot be purchased directly by investors. Past performance is no guarantee of future results. On 9/28/18, the Global Industry Classification Standard (GICS) was reconstituted and the Telecommunications Services sector was renamed Communication Services. GICS sector information for periods prior to 9/28/18 may not necessarily be comparable to the reconstituted sectors.

Looking at sector laggards for the fourth quarter and for the full year, defensive sectors, including consumer staples and utilities, lagged as economic growth was more resilient than expected, while higher rates (for most of 2023) reduced the demand for high-dividend-yielding sectors. Consumer staples and utilities posted negative returns for 2023 after being the best relative performers in 2022.

Switching to fixed income markets, the leading benchmark for bonds (Bloomberg Barclays U.S. Aggregate Bond Index) realized a positive return for the fourth quarter and for the full year as falling inflation and expectations for rate cuts in 2024 pushed bonds higher.

Looking deeper into the fixed-income markets, longer-duration bonds outperformed those with shorter durations in the fourth quarter as bond investors reacted to lower-than-expected inflation and priced in future Fed rate cuts. For the full year, however, shorter-duration debt outperformed longer-term bonds as high inflation readings through the first three quarters of 2024 weighed on the long end of the yield curve.

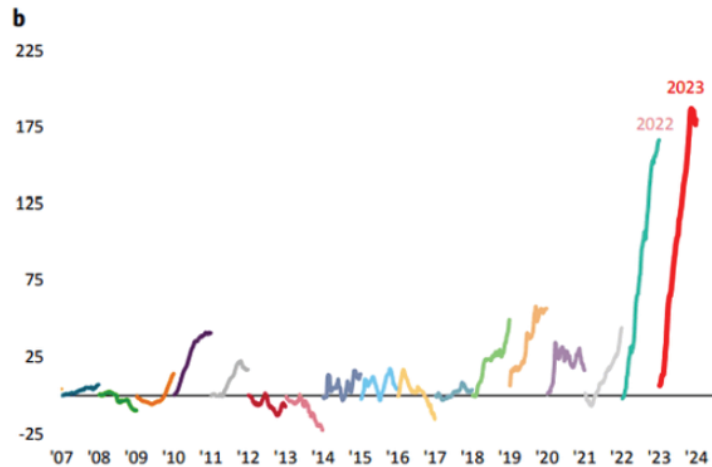
Turning to the corporate bond market, both high-yield and investment-grade bonds posted sharply positive returns for the fourth quarter as investors embraced the idea of lower interest rates and reduced recession chances. For the full year, high-yield corporate bonds posted a very strong return and outperformed investment-grade corporate debt as the resilient economy pushed investors to embrace more risk in return for a higher yield.

U.S. Bond Indexes	Q4 Return	2023 Return
BBgBarc U.S. Agg Bond	6.82%	5.53%
BBgBarc U.S. T-Bill 1-3 Mon	1.38%	5.14%
ICE U.S. T-Bond 7-10 Year	6.42%	3.38%
BBgBarc U.S. MBS (Mortgage-backed)	7.48%	5.05%
BBgBarc Municipal	7.89%	6.40%
BBgBarc U.S. Corporate Invest Grade	8.50%	8.52%
BBgBarc U.S. Corporate High Yield	7.16%	13.44%

Source: YCharts

2023: The Year of High Interest and Risk-Free Treasury Bills

For the first time in over 18 years, investors could receive over 5% in money markets. The chart to the left shows the surge of money that was invested in money markets in 2023, over $5.8 trillion dollars. When the Federal Reserve starts to lower interest rates, where will investors allocate these funds that they were receiving over 5% in interest?



Another area that investors allocated a record amount of money in 2023 to receive anywhere from 5.25% to 5.50% annualized interest rates were in risk-free 3- to 6-month T-Bills. This was part of our strategy of purchasing short-term T-Bills and reinvesting at potentially higher rates when the T-Bills matured.

As the chart to the left shows, over $1.3 trillion dollars was invested in cash instruments such as money markets, and over $177 billion in Treasury bonds, followed by investment-grade bonds and then equities.

FEDERAL RESERVE

Fed holds rates steady, indicates three cuts coming in 2024

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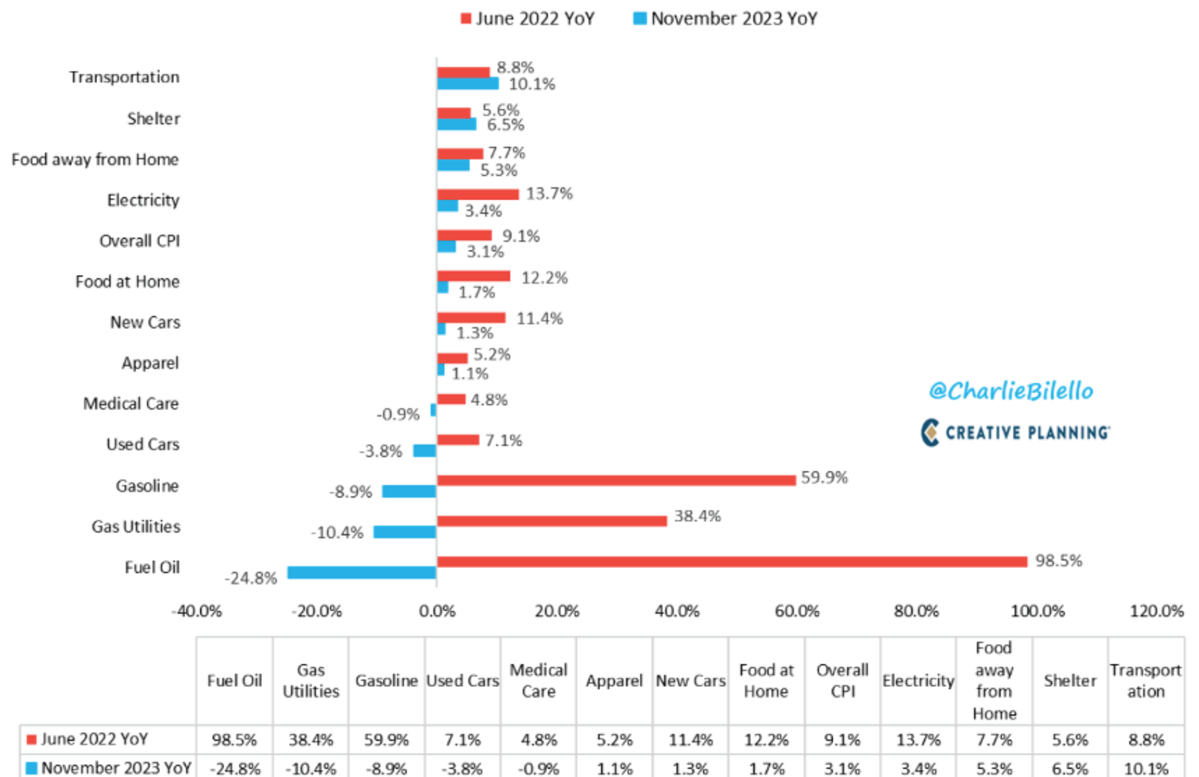
Don’t Fight the Fed

Federal Reserve Chairman Jerome Powell said in his press conference on 12/13/23, “The reason you wouldn’t wait to get to 2% (inflation) to cut rates is that policy would be...too late. I mean, you’d want to be reducing restriction on the economy well before 2% because—or before you get to 2% so you don’t overshoot, if we think of restrictive policy as weighing on economic activity. You know, it takes a while for policy to get into the economy, affect economic activity, and affect inflation.” The Federal Reserve has forecasted three rate cuts in 2024 and five cuts in 2025.

As a result, the Federal Reserve did not raise interest rates at its December meeting. Rates are still at 22-year highs of 5.5%. The reason for the Fed’s decision comes down to inflation. Overall, inflation figures have dropped from a high of 9.1% in June 2022 to 3.1%, as reflected in November’s inflation report. What’s driving that decline? Lower rates of inflation in Fuel Oil, Gas Utilities, Gasoline, Used Cars, Medical Care, Apparel, New Cars, Food at Home, Electricity, and Food Away From Home. Shelter and Transportation are the only major components that have a higher inflation rate today than June 2022.



	Fuel Oil	Gas Utilities	Gasoline	Used Cars	Medical Care	Apparel	New Cars	Food at Home	Overall CPI	Electricity	Food away from Home	Shelter	Transportation
June 2022 YoY	98.5%	38.4%	59.9%	7.1%	4.8%	5.2%	11.4%	12.2%	9.1%	13.7%	7.7%	5.6%	8.8%
November 2023 YoY	-24.8%	-10.4%	-8.9%	-3.8%	-0.9%	1.1%	1.3%	1.7%	3.1%	3.4%	5.3%	6.5%	10.1%

Prices are still rising, and that’s why we are still paying more for most goods and services. But inflation is rising more slowly now (that’s what that 3.1% number means). We expect this process to continue, with consumer prices climbing, but at a slower pace. Yes, they might fall in a particular month when energy prices drop, but even in those months, core prices may continue to rise.

One of the main contributors behind the slowdown in inflation is that supply chains have normalized for now. However, things can change with the rise of any major global conflict or disaster as we are currently experiencing with the conflict in the Middle East and the change in shipping routes and increase in container rates.

During the Federal Reserve's press conference, Jay Powell mentioned in his remarks that declaring victory over inflation would be premature and that it's positive to see the progress on inflation. The Federal Reserve's goal is still to get inflation back down to 2%, which has been their arbitrary inflation target for years.

Q1 and 2024 Market Outlook

What a difference a year makes.

At this time last year, the S&P 500 had just logged its worst annual performance since the financial crisis, the Fed was in the midst of the most aggressive rate hike campaign in decades, inflation was above 6%, and concerns about an imminent recession were pervasive across Wall Street.

Now, as we begin 2024, the market outlook couldn't be much more positive. The Fed is done with rate hikes and cuts are on the way, likely in early 2024. Economic growth has proven more resilient than most could have expected, and fears of a recession are all but dead. Inflation dropped substantially in 2023 and is not far from the Fed's target, while corporate earnings growth is expected to resume in the coming year.

Undoubtedly, that's a more positive environment for investors compared to the start of 2023, but just like overly pessimistic forecasts for 2023 proved incorrect, as we look ahead to 2024, we must guard against complacency because at current levels both stocks and bonds have priced in a lot of positives in the new year.

Starting with Fed policy, Fed officials are forecasting three rate cuts in 2024, but investors are currently pricing in six rate cuts in 2024, the first one occurring in March or May. That's a very aggressive assumption, and if it is incorrect, we should expect an increase in volatility in both stocks and bonds.

Regarding economic growth, it's foolish to assume just because the economy was resilient in 2023, that it will stay resilient. Obviously, that's the hope, but hope isn't a strategy. The longer rates stay high (and they are still high), the more of a drag they create on the economy. Meanwhile, all the remnants of pandemic-era stimulus are gone and there is some economic data that's starting to point toward reduced consumer spending. Point being, it is premature to believe the economy is "in the clear," and a slowing of growth is something we will be on alert for as we start the new year, because that would also increase market volatility.

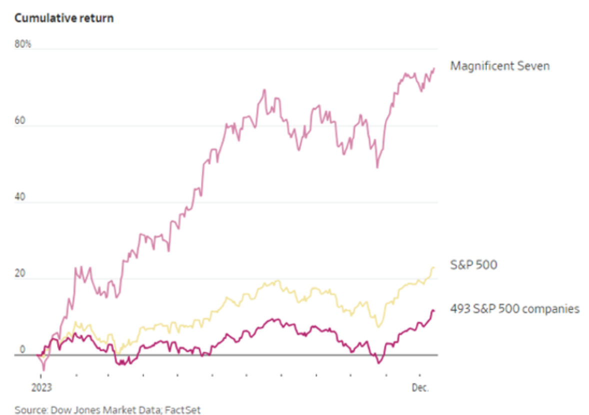
Inflation, meanwhile, has declined sharply, but it still remains solidly above the Fed's 2% target. Many investors expect inflation to continue to decline while economic growth stays resilient, a concept traders coined "Immaculate Disinflation." However, while that's possible, it's important to point out it's extremely rare as declines in inflation are usually accompanied by an economic slowdown.

Finally, corporate earnings have proven resilient, but companies are now facing margin compression as inflation declines and economic growth potentially slows. Earnings results and guidance in the fourth quarter were not as strong as earlier in 2023, and if earnings are weaker than expected, that will be another potential headwind on markets.

Two Important Differences in 2024

Each year in markets is different, and there are usually many changes from one year to another. But there are two important changes occurring in 2024 that we want to point out, because these changes mean that events that were tailwinds (positive) for stocks in 2023 (falling yields and earnings results) will become neutral to potentially negative in 2024.

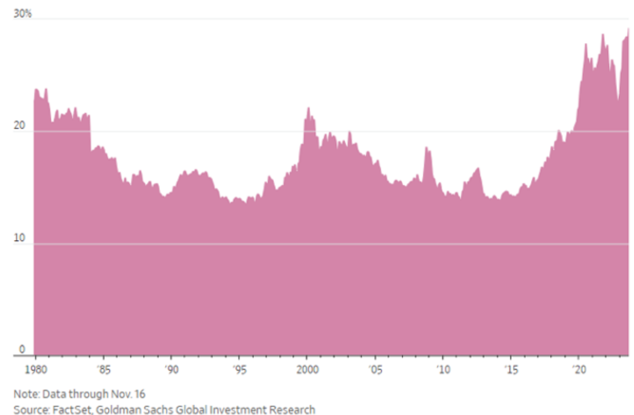
Big tech stocks have jumped 75% in 2023—and now make up about 30% of the S&P 500



Source: Dow Jones Market Data, FactSet

Their combined weighting in the S&P 500 of nearly 30% is the largest share for any 7 companies on record with data going back to 1980.

Combined share of the largest seven companies in the S&P 500



Note: Data through Nov. 16
Source: FactSet, Goldman Sachs Global Investment Research

Change 1: Falling yields won't be positive for stocks. There were two overarching reasons for the rally in 2023: the first was AI enthusiasm powering the "Magnificent Seven" stocks higher and pulling the S&P 500 with it. The second was expectation of a dovish Fed pivot that essentially saved the 2023 rally in late October.

The "Magnificent 7" (Apple, Microsoft, Google, Amazon, Nvidia, Tesla, and Meta) have gained 75% in 2023 versus a gain of 12% for the remaining 493 companies in the S&P 500.

Falling interest rates were a clear positive in 2023 because they 1) eased stock market valuation headwinds and 2) signaled that Fed hikes were ending, which reduced recession changes. But as we start 2024, the dovish Fed pivot is fully priced into stocks with the S&P 500 just under 4,800, and the market has priced in six Fed rate cuts and year-end 2024 fed funds below 4%.

So, the dovish pivot and expected easing of policy is already priced into stocks and Treasuries. If we see the 10-year Treasury yield continue to fall to the low 3% or sub 3% range, that's not going to be a major tailwind for stocks because that won't be forecasting a dovish Fed, it'll be forecasting slowing growth. And those falling yields will then become a harbinger of a potential economic slowdown and not the welcomed signal of a Fed that's finally turning dovish.

Change 2: Earnings results won't have low expectations to excuse poor performance. S&P 500 earnings weren't particularly great in 2023, but they were much better than some of the awful expectations that were prevalent when the year started. As we start 2024, it's the total opposite. Consensus S&P 500 earnings growth is nearly 10% year over year, well above the longer-term averages of around 5% annual growth. And keep in mind, at 4,800 the S&P 500 is trading over 19.5x that $245 earnings estimate, which means there's little room for disappointment from a valuation perspective. Bottom line, "okay" earnings won't be good enough, and we got a preview of that in the Q3 numbers (which weren't great), and especially in December as results were generally poor. That doesn't mean the upcoming Q4 earnings season (which begins in mid-January) won't be positive, but for it to be positive, it'll have to be because of actual good results, not "better-than-feared" results that were good enough in 2023. Bottom line, the markets will need something "new" to power stocks higher in 2024 because the dovish pivot (which powered stocks higher since October) is fully accounted for while low expectations for earnings and economic growth no longer exist. That doesn't mean we won't get new, positive influences on stocks, but it will have to come from something new in 2024 because the "low-hanging fruit" of a dovish pivot and not-as-bad-as feared earnings have already been picked to fuel the Santa rally.

Five Market Assumptions to Know As We Start 2024: The S&P 500 is starting 2024 trading at a very lofty 19.5x valuation, and while I'm not going to say that valuation is unjustified, I will say that valuation makes several key, positive assumptions about critical market influences in the coming year. And how reality matches up with those assumptions will determine whether stocks extend the rally (and the S&P 500 hits new highs and makes a run at 5,000) or gives back much of the Q4 rally. As such, I want to start 2024 clearly defining the five most important assumptions investors are making right now, because it's how these events occur—versus these assumptions—that will determine if stocks and other assets rise or fall in Q1 and 2024.

Assumption 1: Fed cuts rate six times for 150 basis points of easing and a year-end fed funds rate below 4.0%. The main factor behind the S&P 500's big Q4 rally was the assumption that the Fed was done with rate hikes and would be cutting rates early and aggressively in 2024. How do we know this is a market assumption? Fed fund futures. According to fed fund futures, there's a 70%-ish probability the fed fund rates end 2024 between 3.50% - 4.00%.

Assumption 2: No economic slowdown. Markets haven't just priced in a soft landing, they've priced in effectively no economic slowdown as investors expect growth to remain resilient and inflation to decline (the oft-mentioned "Immaculate Disinflation") a concept that's possible, but has never actually happened to my knowledge

How do we know this is a market assumption? The market multiple (or how expensive is the stock market). The S&P 500 is trading at 19.5x the $245 expected S&P 500 earnings expectation. A 19.5x multiple is one that assumes zero economic slowdown.

Assumption 3: Solid earnings growth. Markets are expecting above-average earnings growth for the S&P 500 to help power further gains in stocks. How do we know this is a market assumption? The consensus expectations for 2024 S&P 500 earnings per share are mostly between $245-$250. That's nearly 10% higher than the currently expected $225 per share earnings for last year (2023), which points to very strong annual corporate earnings growth.

Assumption 4: No additional geopolitical turmoil. Despite the ongoing Russia-Ukraine war, Israel-Hamas conflict and escalating tensions between the U.S. and Iranian-backed militias throughout the Middle East, the market's assuming no material increase in geopolitical turmoil. How do we know this is a market assumption? Oil prices. If markets were nervous about geopolitics, Brent Crude prices would be solidly higher than the current $77/bbl. Oil prices in the high $80s to low $90s reflect elevated geopolitical concern, while prices above $100/bbl reflect real worry.

Assumption 5: No domestic political chaos. 2024 is an election year in the U.S. The Republican frontrunner, Donald Trump, is facing a long list of various civil and criminal charges along with challenges to whether his name will be on the ballot in certain states. Meanwhile, there has been no long-term compromise on funding the government, so shutdown scares remain a real possibility. And that's before we get into the heart of election season later this year. How do we know this is a market assumption? Treasury yields. A 3.80% yield on the 10-year Treasury does not reflect much domestic political angst. If markets become nervous about the U.S. political situation and/or fiscal situation in the U.S., the 10-year yield would be sharply higher than it is now (well above 4.00%, like we saw in the late summer/early fall). Bottom line, these market assumptions aren't necessarily wrong. Events could unfold the way the market currently expects. But these assumptions are aggressively optimistic, and it is how events unfold (versus these expectations or on an absolute scale) that will determine how stocks and bonds trade to start the year.

Consensus Forecasts From Analysts and Economists (and Mainstream Media) Have Been Wrong Over the Last 3 Years

As we look toward 2024 in the markets and consider the past few years, I can't help but feel as though we are in a proverbial canoe and the investing public is violently leaning to one side of the canoe and then the other, causing it to nearly tip each time. Here's what I mean. Think back to December 2021. The S&P 500 had just hit an all-time high. The impact of the pandemic was still being felt, but tech companies were surging and leading the market higher as the investing public was convinced we were in a new "hybrid" world that was here to say.

Fueled by stimulus and forced savings, economic growth was strong, inflation was rising, and markets admitted that the Fed needed to hike rates in 2022 but didn't think it'd be that bad. Put simply, market sentiment was resoundingly bullish, and while investors admitted there were some issues, they were minimized and the outlook on December 28th, 2021, was very, very positive.

Of course, that optimism (market sentiment) was misguided. The Fed was much more aggressive on rate hikes, inflation exploded, growth slowed, and the S&P 500 dropped 19.4%. Put simply, consensus was universally bullish and consensus was absolutely wrong. Now think back to December 2022. Investors were despondent. The S&P 500 was ending the worst year in over a decade, the Fed was massively hiking interest rates, inflation wasn't breaking, recession fears were surging, and investors were convinced we were facing either 1) stagflation or 2) an imminent recession. Of course, that pessimism was unfounded as growth remained resilient, inflation was broken, and the Fed dovishly pivoted. Put simply, the consensus was universally bearish, and consensus was absolutely wrong. Will consensus be spectacularly wrong again in 2024?

For the first time in 22 years, analysts were forecasting that the S&P 500 would end 2023 down in price. What happened? Just the opposite. This is another reason why we focus on market sentiment and why we discuss the fear and greed index to help guide us in stock market sentiment.

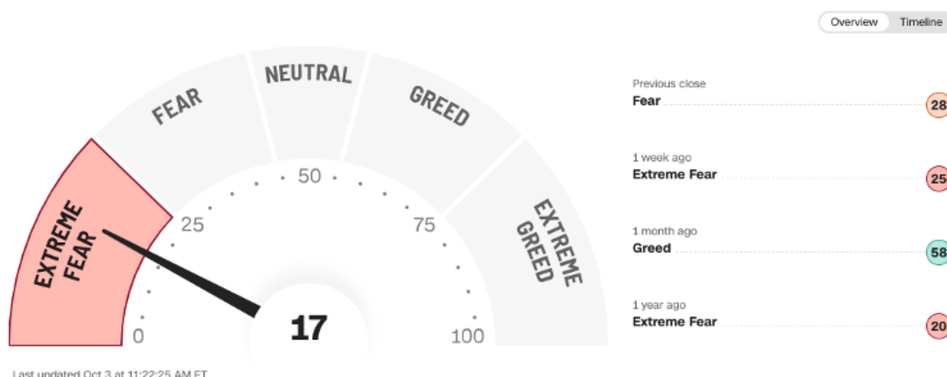
Now, as of December 2023, the consensus is universally bullish—again. To illustrate the bullishness, on December 15, 2023, the S&P 500 ETF (SPY) recorded the biggest inflow of $20.8 billion since the fund's inception in 1993. According to Bloomberg Intelligence, it was the largest one-day flow for any ETF. The chart below shows the greatest inflow of assets since late 2019 when the ETF recorded inflows of over $10 billion.

The consensus view is that the economic soft landing is all but assured. The Fed will cut six times next year but not because of slowing growth, and instead because inflation is about to go into some sort of freefall. Despite numerous geopolitical hot spots, none of them will get materially worse, U.S. politics won't be a problem (it's an election year), and despite a potentially slowing economy and margin compression, companies in the S&P 500 will grow earnings by nearly 10% this year. The 5,000 level on the S&P 500 isn't a matter of "if," it's a matter of "when."

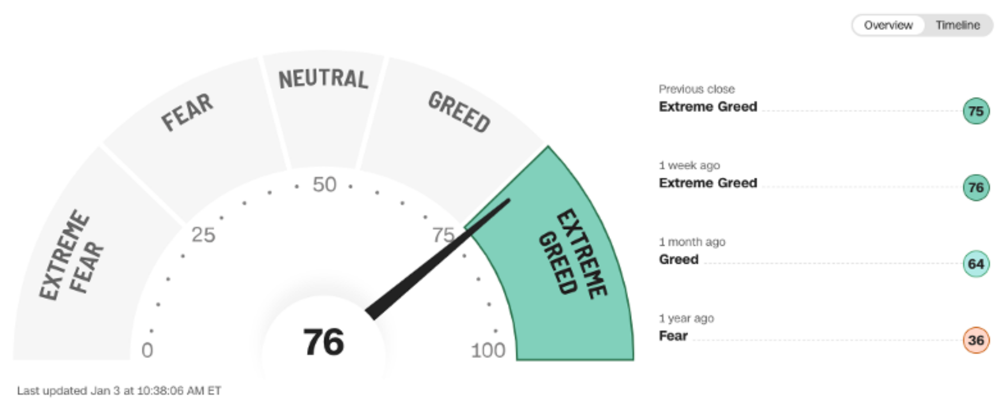
That all may come true and that might be exactly how 2024 works out. The reality of a market in any given year hardly ever matches the consensus, and it almost never matches the consensus when it's this sure of the outcome. I hope the consensus is right. I hope that in a year I'm writing to you and the S&P 500 is above 5,000 and it's been a great year. But this universally bullish expectation makes me think everyone is leaning toward one side of the canoe when in reality, we need to be in the middle, because there are real, legitimate risks in the new year. We can still have a growth slowdown and a recession (the Fed's record on soft landings isn't a good one). Earnings growth can falter as demand slows and margins compress. Geopolitics can provide real, negative surprises. Inflation can bounce back. None of these events would be shocks, although, thankfully, they are not the most likely case—at least in the near term. Bottom line, I view part of my job as making sure you have someone giving you agenda-free analysis that pulls you back to the middle of the proverbial canoe. And as we start 2024, that's what you can expect us to continue to do.

The Bull/Bear Indicator

Finally, I want to revisit our bull/bear indicator; following is the one from when we wrote our Q3 2023 market update. (You can go here to view the CNN Fear & Greed Index.1) The reading was at 17, which is indicating extreme fear in the market. In other words, there were opportunities being created in areas of the market (which we took advantage of at the time).

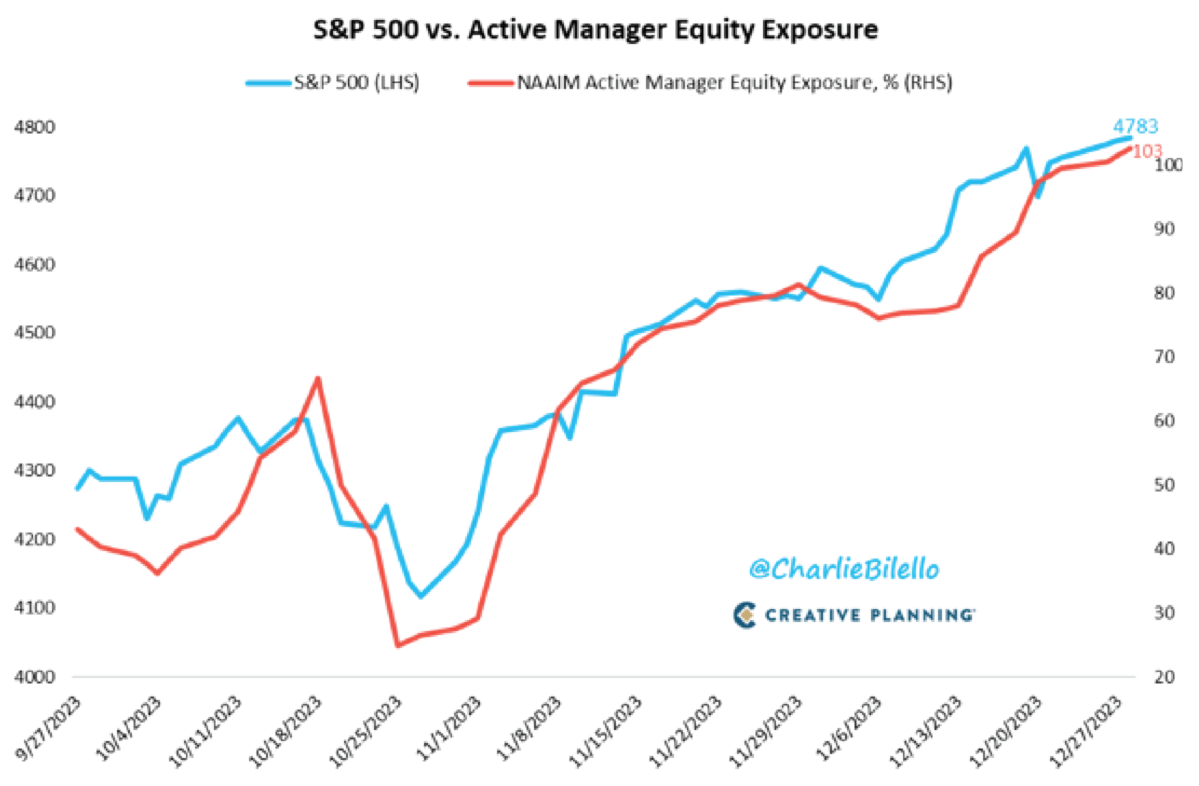


Here is the bull/bear indicator as of January 3, 2024. We have gone from extreme fear in October 2023 to extreme greed in January 2024. This is not a time to be buying. Instead, it has been a time to take profits in some positions and wait for a better opportunity.



And as we've seen throughout history, these moments of extreme pessimism and fear—like what we're seeing right now—make the best opportunities for investors. We saw it back in 2009, when everyone was still too spooked to buy. And yet it turned out to be the greatest buying opportunity in American history.

Another example of extreme bullishness in the stock market is through active mutual fund and ETF managers. They had less than 25% exposure to equities in late October when the S&P 500 was at 4,100. The week of December 29th, their equity exposure jumped above 100% (leveraged long) with the S&P 500 approaching 4,800 and a new all-time high. This is the highest exposure since November 2021.



Observations for 2024

I will wrap up this update with a couple of observations we believe could unfold in 2024. First, we do not make predictions about the economy or the stock market since it is a fool's game. However, there are several areas we are monitoring in 2024:

1. Volatility could pick up dramatically in 2024, and trading ranges could be quite large.
   The first half of 2024 could end up being much better than the second half, with the potential for the S&P 500 to reach a new all-time high, pointing us to the 4997-5057 region in the S&P 500.
2. We could see a large selloff in the 2H of 2024 if it really isn't different this time and we do get a recession or other financial crisis.
3. While we agree that the "higher" part of the "higher for longer" interest rate message is likely now complete, the "longer" part is probably not. We are exercising caution to not get overly enticed by the prospect of imminent rate cuts. We remain in the "higher for longer" camp, and although we expect a further slowdown in the U.S. economy, we do not believe the Federal Reserve will cut six times to match what the interest rate market is forecasting.
4. The banking crisis is not over. We just saw the fastest rate hikes since the 1970s combined with the large bank failures in March. We may see more commercial real estate bankruptcies impact regional banks which hold a large percentage of the commercial real estate loans.
5. We do not believe this is a buy-and-hold market environment. There will be opportunities to take advantage of by being patient. Legendary investor and partner of Warren Buffett, Charlie Munger, who recently passed away, said, "The money isn't made in the buying or the selling, it's made in the waiting."

Howard Marks, co-chairman of private equity firm Oaktree, who specializes in bonds and credit markets, mentioned the following in his December commentary:

What does this mean for investors in 2024? I've long said I don't put much stock in macro forecasts—especially my own—but let's assume that inflation does come down near the Fed's 2% target and stays there for a while. Does that mean we'll return to a pre-pandemic world with interest rates near zero?

I'd say "no." Interest rates don't decline just because they're not being raised, so returning to 2% inflation doesn't necessarily mean a significant interest rate cut is imminent. Additionally, a return to consistent sub-2% inflation seems unlikely, especially given trends like slowing globalization and rising union influence. Finally, the current level of interest rates is much closer to the long-term historical average than what most investors working today are used to. I imagine when inflation has been fully conquered, rates will be lower than they are today, but not back near zero.

Considering all this, what are my expectations for the investment environment in 2024 and beyond? I'll repeat what I wrote last December in Sea Change:

> *...if you grant that the environment is and may continue to be very different from what it was over the last 13 years—and most of the last 40 years—it should follow that the investment strategies that worked best over those periods may not be the ones that outperform in the years ahead.*

So, in conclusion, while I still think the preponderance of the evidence suggests that we have higher to go in early 2024, I do not want anyone to lose sight of the bigger picture. We are still quite likely completing the current bull market. We need to balance our perspective as we look toward a potentially long-term bear market later in 2024. We will be updating our fixed-income outlook in a separate report.

We're Dedicated to You

Bottom line, while undoubtedly the outlook for markets is more positive this year than it was last year, we won't allow that to breed a sense of complacency, because as the past several years have shown, markets and the economy rarely behave according to Wall Street's expectations.
As such, while we are prepared for the positive outcome currently expected by investors, we are also focused on managing both risks and return potential. Because the past several years have also demonstrated that a well-planned, long-term focused and diversified financial plan can withstand virtually any market surprise and related bout of volatility, including multi-decade highs in inflation, historic Fed rate hikes, and geopolitical unrest.

We understand the opportunities and risks facing both the markets and the economy, and we are committed to helping you effectively navigate this challenging investment environment. Successful investing is a marathon, not a sprint, and even intense volatility is unlikely to alter a diversified approach set up to meet your long-term investment goals.

Therefore, it's critical for you to remain patient and stick to our plan, as we've worked with you to establish a unique, personal allocation target based on your financial position, risk tolerance, and investment timeline.

We thank you for your ongoing confidence and trust, and please rest assured that our entire team will remain dedicated to helping you successfully navigate this market environment.

Please do not hesitate to contact us with any questions, comments, or to schedule a portfolio review.

Sincerely,

Matthew Gaude   J. Shawn McGuire

About Matthew

Matthew Gaude is an *investment advisor representative and the co-founder of Live Oak Wealth Management, a financial services firm in Roswell, Georgia. He serves the planning and investment needs of corporate employees, those approaching or in retirement, and 401(k) plan sponsors. Working first as a commodity broker and then as a Business Development Manager for a national broker-dealer in previous jobs, he has the insight and experience to help clients understand the complexities of the market and implement strategies to minimize risk. To learn more about Matthew, connect with him on LinkedIn or visit www.liveoakwm.com.

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