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Investment and Financial Consultants

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2023 ECONOMIC AND FINANCIAL MARKETS REVIEW

Despite adverse world events, the stock market rallied during the fourth quarter of 2023 as it became evident that the Federal Reserve Board will no longer need to continue raising interest rates to fight inflation. The Fed has raised interest rates aggressively since March 2022 to slow the economy and reduce inflation. As economic growth began to show signs of moderating and inflation showed signs of declining, investors became confident that the Fed could ultimately engineer a “soft landing.” This means the Fed could potentially slow the economy just enough to reduce inflation without creating a recession, which would negatively affect stock prices. As a result of the fourth quarter rally, the S&P 500 Index ended 2023 up 24.23%, while the Dow Jones Industrial Average gained 13.70% last year. The Bloomberg Intermediate U.S. Government/Credit Bond Index increased by 5.24% during 2023.

While the recent stock market rally is encouraging, it is not a foregone conclusion that the Fed has engineered a “soft landing.” Typically, it takes up to one year for the economy to digest the full impact of the Fed’s interest rate increases. Therefore, if it turns out that the Fed raised rates too much over the past couple of years, it could still cause an economic recession later this year. The reason the economy weakens when the Fed raises interest rates is because it costs businesses and consumers more money to borrow. If businesses and consumers spend far less money due to higher borrowing costs, the economy could go into a recession. If a recession occurs this year, stocks will likely decline because corporate earnings will generally deteriorate. The Fed would be forced to lower interest rates to help the economy grow again.

The stock market’s focus on the Fed and its interest rate policy is so powerful that it has outweighed concerns regarding other significant events, such as the wars in the Middle East and Ukraine. This is not uncommon, as the market typically shrugs off the initial impact of geopolitical events and focuses more on the direction of interest rates, the economy, and corporate earnings. However, if the war in the Middle East spreads to other countries or the U.S. becomes further engaged, stock investors may become nervous, leading to a stock market decline. Also, while financial markets typically perform well during election years, if this election year brings unwanted surprises leading up to November, stock investors may become nervous and sell shares, creating a market downturn.

Last year, a small number of large technology stocks appreciated significantly. These stocks carry a very large weighting in the market-weighted S&P 500 Index, which is one of the reasons this index performed so well last year. These were primarily companies focusing on artificial intelligence. However, many other companies in other industries were left behind. For example, small-size and mid-size company stocks generally did not perform as well as large-company stocks. Large-company, value-oriented stocks did not perform nearly as well as large-company growth stocks. Foreign stocks also did not perform as well as domestic stocks. This year, for the stock market to continue to advance, it is likely that more companies in more economic sectors will need to appreciate. In other words, it will be important for the stock market gains to broaden over the coming months for the bull market in stocks to continue.

One positive for stocks this year is that investors are generally pessimistic regarding the stock market and the economy. Often, when investors feel negative, the stock market appreciates, and when investors are too positive, the stock market declines. The reason is that when investors are too negative about the stock market, there is usually a lot of money on the sidelines, which ultimately finds its way into the stock market and boosts prices. However, when investors are too confident, they are generally already fully invested, and the market is vulnerable to a sell-off.

We continue to favor large-company stocks that can generate profits globally. However, we are becoming more optimistic that smaller companies will start to perform better than they have in the coming year. We are also watching other areas of the markets that have generally underperformed to see if their fortunes improve. Finally, if it appears that interest rates are going to decline this year, we may recommend lengthening the duration of bonds, as falling interest rates are more favorable for longer-term bonds than shorter-term bonds.

As always, we will continue to monitor ongoing economic and financial market conditions. In the meantime, please contact us if you have any questions regarding your portfolio or the financial markets in general.

* *Index returns were obtained from the Wall St. Journal and Bloomberg on December 31, 2023.*