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The Fourth Quarter: Summary and Market Outlook

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Markets staged an impressive reversal in the fourth quarter, driven by a surprising dovish pivot by the Federal Reserve (Fed), coupled with solid economic activity and a continued decline in inflation.

However, the strong fourth quarter performance obscured the fact that stocks and bonds were under significant pressure at the beginning of the quarter.

Initially, Treasury yields rose in early October, which weighed on stock and bond prices just as they did in the third quarter. On October 7, Hamas soldiers infiltrated settlements in Israel, reigniting geopolitical tensions in the Middle East. The immediate market fallout resulted in higher oil prices due to fears of a broader regional war, fueling a further increase in Treasury yields as investors braced for an oil-driven spike in inflation.[1] Combined with a lackluster earnings season, these factors led the S&P 500 to fall to its lowest levels since mid-May, while the 10-year Treasury yield touched 5.00% for the first time since the mid-2000s.[2]

However, the markets reversed course when Fed Governor Chris Waller hinted that rate hikes were over and that rate cuts might occur in 2024.[3] Both stocks and bonds reacted positively, rallying hard by the end of the month to recover and finish well off the October lows.[4]

The positive momentum continued in November, with the S&P 500 posting its best monthly return of 2023.[5] Factors contributing to this rally included several Fed officials echoing Waller's comments, leading investors to price in rate cuts as early as May of 2024.[6] The Israel/Hamas conflict also remained contained, resulting in lower oil prices, which alleviated prior concerns on the potential for an oil-driven spike in inflation. And inflation continued to decline. The year-over-year increase in the Consumer Price Index dropped to 3.14%, reinforcing investor expectations for rate cuts in the first half of 2024.[7]

At the Federal Open Market Committee (FOMC) meeting on December 13, Fed officials delivered on these expectations, forecasting three rate cuts in 2024, one more than previously expected.[8] This pivot helped fuel a further year-end rally that saw the S&P 500 reach its highest level since the prior market peak in January 2022.[9]

2023 ended up being a year of surprises for the markets. The much-anticipated recession never arrived, inflation fell faster than expected, corporate earnings proved resilient, and the Fed surprised markets by pivoting to a less restrictive monetary policy stance, resulting in substantial gains for stocks.

As we begin 2024, the market outlook appears supportive. The Fed has signaled the end of rate hikes and the beginning of cuts. Economic growth has proven more resilient than anticipated and fears of a recession have diminished. Inflation appears to be under control, approaching the Fed's target, and corporate earnings growth is expected to resume in the coming year.

However, despite the positive outlook, we should guard against complacency. Both stocks and bonds have already priced in many positives at current levels. Regarding Fed policy, while officials have forecasted three rate cuts in 2024, investors are pricing in six, with the first one expected in March or May.[10] This significant discrepancy could lead to increased volatility if market expectations prove incorrect.

Concerning economic growth, resilience in 2023 is no guarantee that resilience will persist. The effects of high interest rates may take some time to filter through the economy. Already, signs of reduced consumer spending are emerging as pandemic-era stimulus fades.[11] It may be premature to conclude that the economy is in the clear, and if growth slows, market volatility is likely to increase.

And while inflation has declined sharply, it remains above the Fed's 2% target. Continued disinflation while maintaining resilient economic growth (which some have termed "Immaculate Disinflation") is rare, as declines in inflation typically accompany an economic slowdown.

Lastly, although corporate earnings have proven resilient so far, margin compression may result if inflation declines and economic growth slows. Earnings results and corporate guidance in the fourth quarter were not as strong as earlier in 2023. If earnings reported in Q1 are weaker than expected, that will be another potential headwind.

In summary, the market outlook is more positive in 2024 than last year but caution against complacency is essential. The past several years have demonstrated that markets and the economy often defy Wall Street's expectations. Preparing for positive outcomes is crucial but managing risks is equally important. Regardless of how markets behave, the past several years have proven once again that a long-term focused and diversified financial plan backed by thoughtful asset allocation can withstand just about any market surprise or bout of volatility. We appreciate your ongoing confidence and trust and remain dedicated to assisting you in navigating the challenges of this market environment.

Please feel free to contact your advisor with any questions, comments, or to schedule a portfolio review.

1 https://abcnews.go.com/Business/israel-hamas-war-causes-spike-oil-prices-heres/story?id=103856410#:~:text=in%20oil%20prices.-,Here's%20what%20it%20means%20for%20gas%20costs%2C%20inflation,risks%20for%20consumers%2C%20experts%20said.&text=Oil%20prices%20have%20climbed%20over%20fears%20the%20Israel%2DHamas%20war,region%20and%20threaten%20global%20output

2 https://paralleladvisors.box.com/v/Q42023EconIndicatorsandReturns

3 https://www.cnbc.com/2023/10/18/feds-waller-says-officials-can-wait-watch-and-see-before-acting-on-interest-rates.html

4 https://paralleladvisors.box.com/v/Q42023EconIndicatorsandReturns

5 https://paralleladvisors.box.com/v/Q42023EconIndicatorsandReturns

6 https://www.wsj.com/finance/investing/investors-see-interest-rate-cuts-coming-soon-recession-or-not-d30646c9

7 https://paralleladvisors.box.com/v/Q42023EconIndicatorsandReturns

8 https://www.cnbc.com/2023/12/13/fed-interest-rate-decision-december-2023.html

9 https://paralleladvisors.box.com/v/Q42023EconIndicatorsandReturns

10 https://www.barrons.com/livecoverage/fed-december-meeting-speech-rate-decision-today/card/futures-markets-expect-6-rate-cuts-in-2024-versus-4-earlier-0GuZFQP7CW6pR1VEmOdr

11 https://paralleladvisors.box.com/v/Q42023EconIndicatorsandReturns

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