

Dovish Fed & Continued AI Enthusiasm Drive Markets to Solid Performance

Equity Market Breadth Improved in 4th Quarter

Fourth Quarter 2023

Financial markets staged an impressive reversal in the fourth quarter primarily due to a surprise dovish pivot by the Federal Reserve. Combined with solid economic activity and steady disinflation, the Fed pivot on its interest rate policy drove stocks higher. The S&P 500 index went on a nine-week winning streak, resulting in strong double-digit returns across various equity market indices.

The impressive fourth quarter performance somewhat obscures the fact that both stocks and bonds started the quarter under significant pressure. First, Treasury yields continued moving higher in early October which weighed on markets. Then on October 7th, Hamas soldiers infiltrated settlements in southern Israel, killing and kidnapping more than 1,200 Israelis in the worst attack in decades. The fallout was immediate. Oil prices spiked on fears a broader regional war would ensue between Israel, Hamas, Hezbollah and, potentially, Iran. However, markets reversed when Fed Governor Chris Waller made comments that implied rate hikes were over and an easing rate policy may be coming in 2024.

The positive momentum continued in November as the S&P 500 index posted its best monthly return of the year, rising roughly 9%. Several factors fueled the rally. Numerous Fed officials echoed the earlier dovish commentary from Governor Waller. Secondly, the Israel/Hamas conflict (while devastating) did not spread from the region, thus keeping oil prices contained. Finally, inflation indicators continued to steadily decline. The year-over-year increase in the Consumer Price Index (CPI) dropped to 3.2% and that further fueled expectations that rate cuts would come earlier than anticipated.

The market momentum continued and accelerated in December courtesy of the Federal Reserve. At the December 13th FOMC meeting, Fed officials clearly signaled that rate hikes were over and forecasted three quarter-point cuts in 2024, one more cut than previously telegraphed. Additionally, Fed Chair Powell did little to push back against rising expectations for rate cuts. The S&P 500 rose to its highest level since January 2022 while the Dow Industrials hit a new all-time high. In summary, 2023 was a year of surprises for the markets as the expectations for an economic recession never materialized, inflation fell faster than forecasted, and the Federal Reserve surprised markets by pivoting to a more accommodative policy.

Of course, no recap of last year would be complete without some acknowledgement of the potentially revolutionary impact on business and on society of generative Artificial Intelligence (AI). For most of the year, this potential was largely confined to the performance of the previously discussed “Magnificent Seven” companies. As late as October 31st, the performance of these seven stocks accounted for more than 130% of the S&P 500’s total return. Since then, the market has broadened out considerably. The equal weight S&P 500 was up 16.6% for the last two months of the year, offering hope that the current market rally has stamina.

Drilling down to the sector level, 10 of the 11 S&P 500 sectors finished the fourth quarter with positive returns, while 8 sectors ended 2023 with gains. For the full year, AI enthusiasm was the dominant influence on sector performance. The three most “AI sensitive” sectors, information technology, consumer discretionary, and communications services, massively outperformed the remaining 8 sectors (**see Exhibit A**). The sector laggards for the fourth quarter and the full year were defensive sectors.

Consumer staples and utilities lagged as economic growth and higher interest rates were more resilient than expected. Consumer staples and utilities posted negative returns for 2023 after being the top performer in 2022.

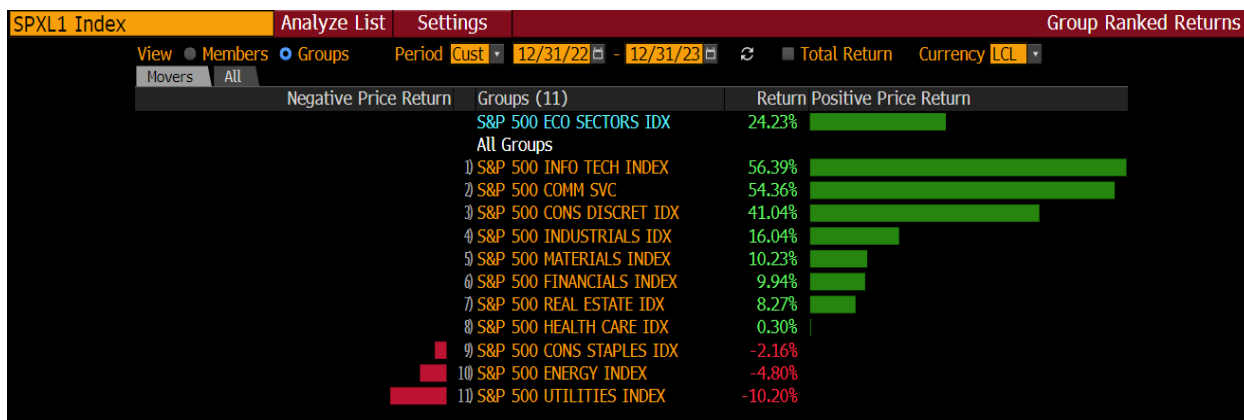


Exhibit A Source: Bloomberg Professional

Foreign markets lagged the S&P 500 in the fourth quarter thanks to muted gains in the emerging markets. Increased geopolitical tensions in the Middle East and lackluster Chinese economic growth contributed to their muted performance. Developed foreign markets outperformed emerging markets in the fourth quarter on better-than-expected inflation readings and rising expectations that other central banks will also cut rates in the new year. For the full-year 2023, foreign developed markets registered solid positive returns. but handily underperformed the S&P 500 thanks primarily to the large gains in U.S. technology stocks.

US Equity Indexes	Q4 Return	YTD
S&P 500	11.68%	26.26%
NASDAQ Composite	13.84%	44.70%
DJ Industrial Average	13.09%	16.18%
S&P 500 Equal Weighted	11.85%	13.84%
Russell 2000 (Small Cap. Stocks)	14.02%	16.88%

Source: Bloomberg Professional

Switching to fixed income markets, the leading benchmark for bonds, Bloomberg Barclays US Aggregate Bond Index, realized a positive return for both the fourth quarter and the full year. Falling inflation and rising expectations for 2024 rate cuts pushed bond prices higher and yields lower. Drilling further into fixed income, longer-duration bonds outperformed those with shorter durations in the fourth quarter as bond investors reacted to lower-than-expected inflation and anticipated rate cuts. The rally for bonds in the quarter was historic. The November and December gains in the broad aggregate index was nearly 9%, its best two-month run since 1990. For the full year, however, shorter-duration debt outperformed longer-term bonds.

US Bond Indexes	Q4 Return	YTD
Bloomberg US Aggregate Bond	6.82%	5.53%
Bloomberg US T-Bill 1-3 Month	1.38%	5.14%
ICE US T-Bond 10-20 Year	11.29%	3.30%

Source: Bloomberg Professional

2024 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 global financial crisis. The Fed was amid the most aggressive rate hike campaign in decades, and inflation was above 6%. Concerns about an imminent recession were pervasive across Wall Street.

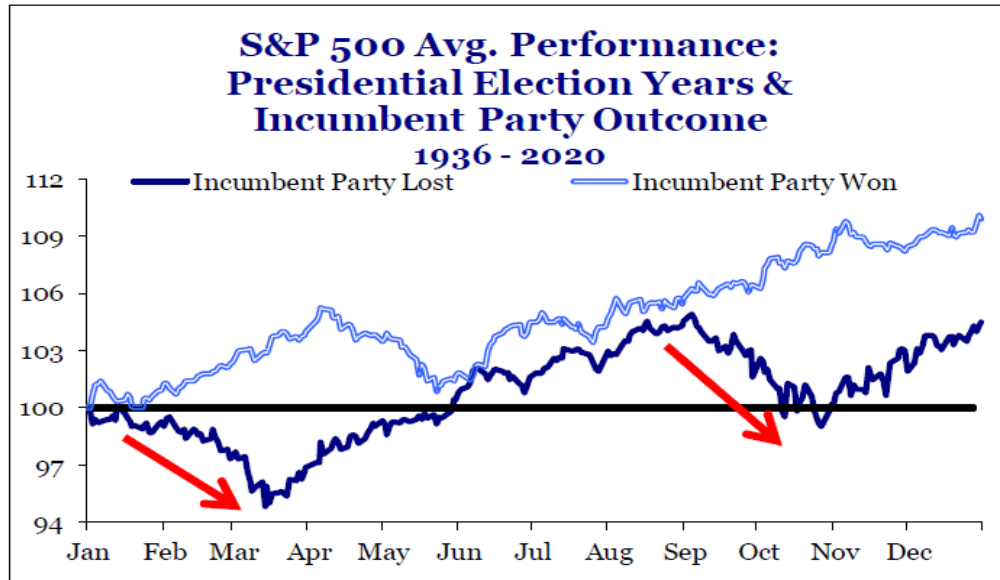
As we begin 2024, the market outlook couldn't be more positive. The Fed has signaled they are done with rate hikes and cuts could start early in 2024. Economic growth has proven more resilient than most could have expected, and fears of a hard landing, i.e., severe recession, are all but dead. Inflation dropped substantially in 2023 and is not too far from the Fed's target while corporate earnings growth is expected to resume in the coming year.

Without a doubt, that's a more positive environment for investors compared to the start of 2023, but just like overly pessimistic forecasts for 2023 proved incorrect, we must guard against complacency. Current levels for both stocks and bonds have priced in a number of positives in a short period of time. Starting with Federal Reserve interest rate policy, Fed officials are forecasting three rate cuts in 2024 but traders are currently pricing in six quarter-point cuts. That's a very aggressive assumption and if it is incorrect, we should expect an increase in volatility. Meanwhile, inflation has declined sharply but it still remains 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 is important to point out that it is an extremely rare phenomenon. Declines in inflation are usually accompanied by economic slowdowns.

Regarding economic and earnings growth, it's foolish to assume because the economy was resilient in 2023 that it will stay resilient. Point being, the longer interest rates stay high, and they are still high relative to recent history, the larger the drag on our economy. Also, all the remnants of pandemic-era stimulus are fading and there is some evidence that consumer spending is beginning to slow. Additionally, S&P 500 corporate earnings have recently emerged from a shallow one-year profit recession, but companies are now facing margin compression as inflation declines and economic growth potentially slows. Earnings guidance in the fourth quarter was not as strong as earlier in the year, and if earnings are weaker than expected, that will be another potential headwind for financial markets this year.

Finally, 2024 is a presidential election year in which a sitting president is trying to be re-elected. Historically, sitting presidents have lots of fiscal and monetary tools to impact the economy. The current administration will attempt to "prime the pump" by expanding efforts to increase student loan cuts, increase green energy production, and restart the Employee Retention Tax Credit. The 2024 U.S. election will be historic! Markets will deal with even more noise than ever. As such, the fundamentals will matter in overcoming this noise. While the path is likely to be rocky (see chart below), the last time the S&P 500

fell in a presidential re-election year was 1948. This 70+ year phenomenon is largely due to the above-mentioned economic stimulus implemented by the incumbents.



Source: Strategas Research Partners

While undoubtedly the outlook for markets is more positive this year, we will not allow that to breed a sense of complacency. As the past several years has shown, markets and the economy rarely behave according to Wall Street's expectations. While we are prepared for the positive outcome currently expected by investors, we are also focused on managing both risks and return potential. Experience demonstrates that a well-structured, long-term focused, and diversified investment portfolio can withstand virtually any market surprise and related bout of volatility. Therefore, it is critical for patience and prudent application of your investment plan. Each client has a unique, personal allocation target based on their financial position, risk tolerance, and investment time horizon.

We thank you for your continued trust. Your SlateStone team will remain dedicated to helping you accomplish your financial goals. Please do not hesitate to contact us with any questions or to schedule a portfolio review.

Sincerely,

SlateStone Wealth's Investment Committee

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