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The Year of the Pivot

As we flip the calendar to 2024, financial markets continue to shrug off concerns over potential Fed missteps, focusing instead on the continued declines in inflation and an expectation of rate cuts in 2024. The Fed continues to orchestrate a near-perfect calibration of economic variables, balancing interest rate policy against growth and inflation metrics. However, the next move may be the hardest one yet – determining when to pivot from tightening to easing. The latest GDP reading, at 4.9% annualized, is much higher than the Fed would like to see and presents a potential roadblock to the pivot decision.

Capital Markets Review

After bearishness drove equity markets in the third quarter, the S&P 500 soared 16.2% after hitting a second-half bottom on October 27, 2023 (Source: FactSet), bringing the return for 2023 to 26.3%. International Developed equities and US Small cap stocks returned 18.2% and 16.9% respectively, while Emerging Markets posted 9.8% on the year. In bond markets, the swift decline in the 10-year Treasury yield that occurred in the fourth quarter prompted a turnaround in longer duration and lower credit quality, as the aggregate bond market ended the year up 5.5% and high yield posted a 13.4% return for the year. Alternative investments, which helped portfolio returns significantly during the low interest rate environment associated with the COVID crisis, posted a 3.1% return for the full year 2023.

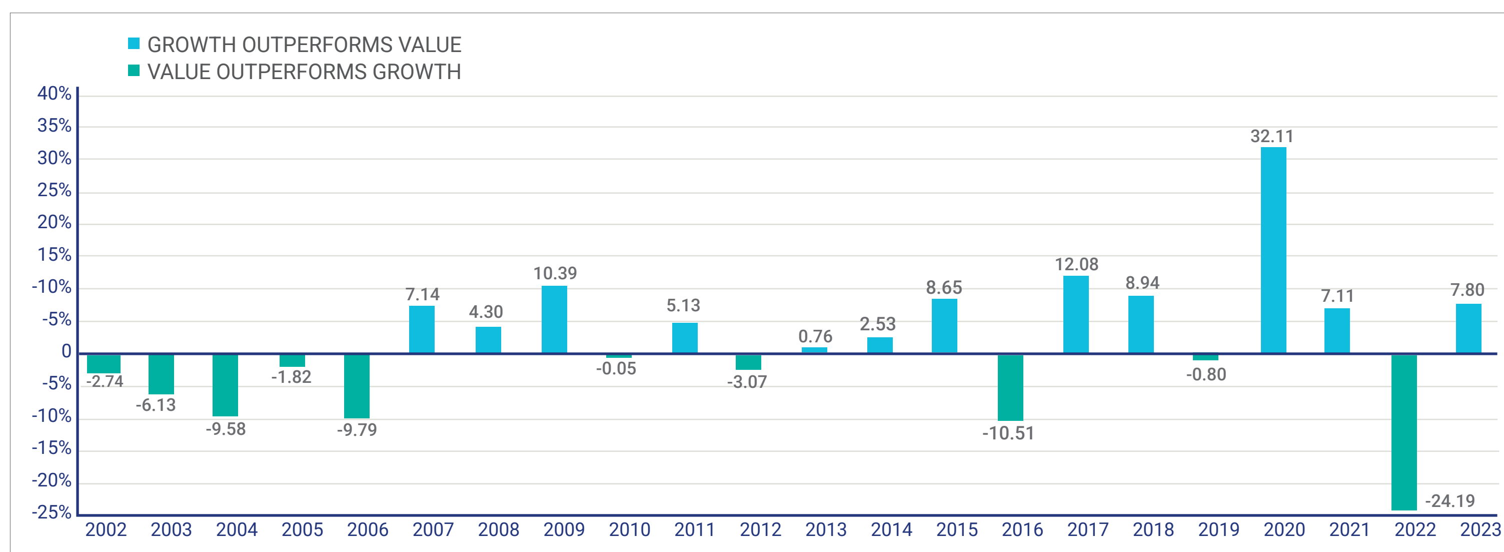
Asset Class Returns

	Asset Class	Index	December 2023	Q4 2023	YTD 2023
Equity	US Large Cap	S&P 500	4.5	11.7	26.3
	US Small Cap	Russell 2000	12.2	14.0	16.9
	International Developed	MSCI EAFE	5.3	10.4	18.2
	Emerging Markets	MSCI EM	3.9	7.9	9.8
Fixed Income	US Investment Grade	Barclays US Agg	3.8	6.8	5.5
	US Inflation-Indexed	Barclays US TIPS	2.7	4.7	3.9
	US High Yield	BBgBarc US Corp High Yield	3.7	7.2	13.4
	EM US$ Debt	JPM EMBI Global	4.7	9.2	11.1
Alternative	Absolute Return	HFRX Global Hedge Fund	1.4	1.7	3.1

Source: Morningstar

As shown in the chart below, the Growth stocks component of the S&P 500 outperformed the Value component for the year, 30.0% to 22.2%. While Value has not maintained a multi-year period of stronger returns than Growth since 2002–2006, a slowing economy could propel value stocks to outperform in 2024.

Relative Annual Performance of Growth Versus Value: 2002–2023



Source: Morningstar
Chart represents S&P 500 Growth annual performance minus S&P 500 Value annual performance.

Sector Review

While the Technology (+57.8%), Communication Services (+55.8%), and Consumer Discretionary (+42.4%) sectors drove market returns for 2023, market breadth expanded in Q4 as Real Estate, Industrial, and Financials all posted double-digit returns.

Sector Returns: Q4 and 2023

Sector	Index	December 2023	Q4 2023	YTD 2023
Technology	S&P 500 Sec/Information Technology	3.8	17.2	57.8
Communication Services	S&P 500 Sec/Commun Services	4.8	11.0	55.8
Consumer Discretionary	S&P 500 Sec/Cons Disc	6.1	12.4	42.4
Industrials	S&P 500 Sec/Industrials	7.0	13.1	18.1
Materials	S&P 500 Sec/Materials	4.6	9.7	12.5
Real Estate	S&P 500 Sec/Real Estate	8.7	18.8	12.4
Financials	S&P 500 Sec/Financials	5.4	14.0	12.1
Health Care	S&P 500 Sec/Health Care	4.3	6.4	2.1
Consumer Staples	S&P 500 Sec/Cons Staples	2.7	5.5	0.5
Energy	S&P 500 Sec/Energy	0.0	-6.9	-1.3
Utilities	S&P 500 Sec/Utilities	1.9	8.6	-7.1

Source: Morningstar

Global Outlook

While European equities posted a very solid 18.2% in 2023, the economic environment continues to post lower GDP growth and higher unemployment levels than the US. This, as well as expectations that the European Central Bank may be slower than the US Federal Reserve in cutting rates, leads us to maintain our current positioning favoring US Equities. In Asia, we view China as the driver of economic health. As China's GDP growth continues to slow, we are hesitant to add meaningfully to Asian equities, despite strong returns in 2023 for Japan's Nikkei 225 (up 31.0%) and the Taiwan TAIEX index (up 31.5%) (Source: Morningstar for all citations in paragraph).

As a result, we have not increased our positions outside of the US.

Economic Estimate Comparison — Real GDP Growth

Country/Region	CY 2021	CY 2022	CY 2023	CY 2024*	CY 2025*	CY 2026*
G7						
United States	5.8	1.9	2.4	**1.2**	**1.7**	**1.9**
Japan	2.6	0.9	1.8	**0.9**	**1.0**	**1.1**
Canada	5.3	3.8	1.1	**0.5**	**2.0**	**1.9**
France	6.4	2.5	0.9	**0.7**	**1.4**	**1.2**
Italy	8.3	3.9	0.7	**0.6**	**1.1**	**1.3**
United Kingdom	8.7	4.3	0.5	**0.4**	**1.2**	**1.6**
Germany	3.1	1.9	-0.2	**0.3**	**1.3**	**1.0**

Source: FactSet. As of 1/4/2024

Economic Estimate Comparison — CPI Inflation

Country/Region	CY 2021	CY 2022	CY 2023	CY 2024*	CY 2025*	CY 2026*
G7						
Japan	-0.2	2.5	3.2	**2.2**	**1.6**	**1.7**
Canada	3.3	6.8	3.8	**2.6**	**2.1**	**2.1**
United States	4.7	8.0	4.1	**2.6**	**2.2**	**2.2**
France	2.1	5.9	5.7	**2.8**	**2.3**	**1.8**
Germany	3.2	8.7	6.0	**2.6**	**2.2**	**2.1**
Italy	1.9	8.8	6.1	**2.1**	**2.0**	**2.0**
United Kingdom	2.6	9.1	7.4	**3.1**	**2.1**	**1.9**

Source: FactSet. As of 1/4/2024

Economic Estimate Comparison — Unemployment Rate %

Country/Region	CY 2021	CY 2022	CY 2023	CY 2024*	CY 2025*	CY 2026*
G7						
Japan	2.8	2.6	2.6	**2.5**	**2.4**	**2.4**
United States	5.4	3.6	3.7	**4.2**	**4.2**	**4.1**
United Kingdom	4.5	3.7	4.2	**4.6**	**4.6**	**4.9**
Canada	7.4	5.3	5.4	**6.4**	**6.5**	**6.2**
Germany	5.7	5.3	5.7	**6.1**	**6.0**	**6.3**
France	7.9	7.2	7.3	**7.4**	**7.0**	**7.1**
Italy	9.5	8.1	7.8	**7.6**	**7.0**	**6.4**

Source: FactSet. As of 1/4/2024

*Estimates by Source & As of Date

Portfolio Positioning

As we move into 2024, our potential portfolio adjustments hinge on the Fed's interest rate policy management. The market clearly expects the Fed to follow an orderly series of 25 basis point rate cuts beginning at the March meeting, as indicated by the CME Group's Fedwatch chart below.

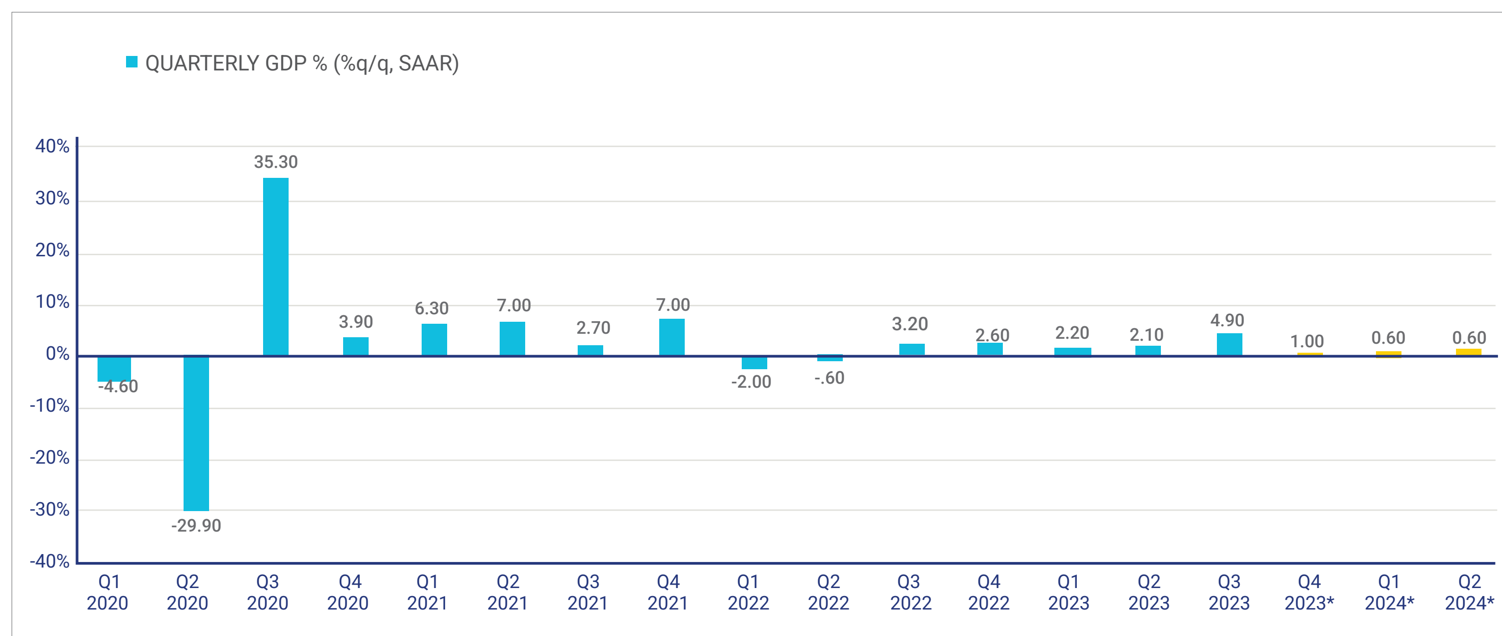
CME Fedwatch Tool - Meeting Probabilities

Meeting Date	325-350	350-375	375-400	400-425	425-450	450-475	475-500	500-525	525-550
1/31/2024				0.0%	0.0%	0.0%	0.0%	8.8%	91.2%
3/20/2024	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	6.0%	64.8%	29.2%
5/1/2024	0.0%	0.0%	0.0%	0.0%	0.0%	5.0%	55.3%	34.9%	4.7%
6/12/2024	0.0%	0.0%	0.0%	0.1%	5.6%	55.1%	34.6%	4.7%	0.0%
7/31/2024	0.0%	0.0%	0.1%	5.0%	49.6%	36.8%	8.0%	0.5%	0.0%
9/18/2024	0.0%	0.1%	4.6%	45.6%	38.0%	10.6%	1.2%	0.0%	0.0%
11/7/2024	0.0%	3.0%	31.6%	40.6%	19.9%	4.4%	0.4%	0.0%	0.0%
12/18/2024	2.5%	26.5%	39.0%	23.6%	7.2%	1.1%	0.1%	0.0%	0.0%

Source: https://www.cmegroup.com/markets/interest-rates/cme-fedwatch-tool.html. As of 1/4/2024

However, the recent reading for third quarter 2023 GDP was a robust 4.9% (Source: FactSet), and the estimate for the fourth quarter is also positive per FactSet's estimates. These data points are not indicative of a slowing or recessionary economy, and that introduces a potential challenge for the Fed. Should growth stay in this range or accelerate, the Fed may find it difficult to embark on their rate reduction campaign. In what might be viewed as a "good news is bad news" scenario, the Fed may be forced to pause for an extended period in order to allow higher rates to slow economic growth. We believe the market is not properly accounting for this scenario. So, while we are quite bullish in the longer term, some short-term volatility would not surprise us in the first half of 2024.

US Real GDP Growth - Stronger in Q3, Forecast to Slow in 2024

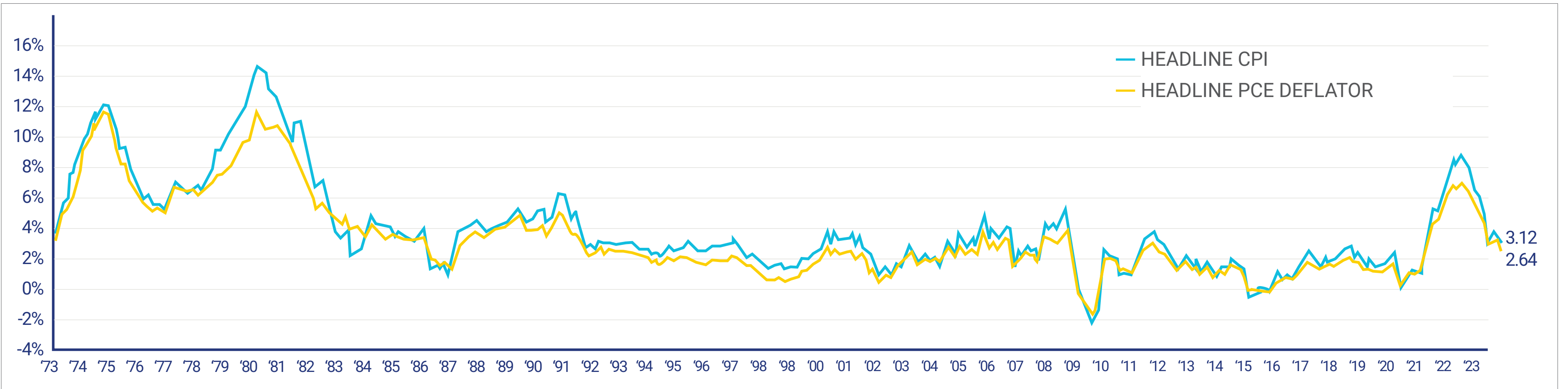


Source: FactSet
*Estimates as of 1/4/2024

Fed Chair Jerome Powell has repeatedly said that the Fed is highly "data dependent". As actual economic data deviates from expected data, volatility is likely to ripple through financial markets with an intensity that matches the magnitude of the deviation. Inflation (see chart below) has been moving lower consistently since peaking above 8%. Unemployment stands at a benign 3.7%, and the civilian labor force participation rate has recovered markedly since the depths of the COVID crisis.

Inflation - Moving in the Right Direction

Headline Consumer Price Index (CPI) and Headline Personal Consumption Expenditures (PCE) Inflation



Source: FactSet
*Estimates as of 1/4/2024

Given the Fed's current focus and uncertain backdrop, how are we positioning equity allocations at this time? First and foremost, we continue to favor US Equities over their International counterparts for the reasons mentioned in our "Global Outlook" section above. We also continue to favor large cap stocks over small cap, as we did in 2023. Should the Fed navigate perfectly in 2024, it's possible that we skip the recession and begin a new economic cycle. If this occurs, small cap stocks are likely to perform well. However, a pause in rate cuts (or even less aggressive rate cutting) may put further strain on smaller companies' borrowing costs. So, we take a "wait and see" approach on small cap for now before increasing positions.

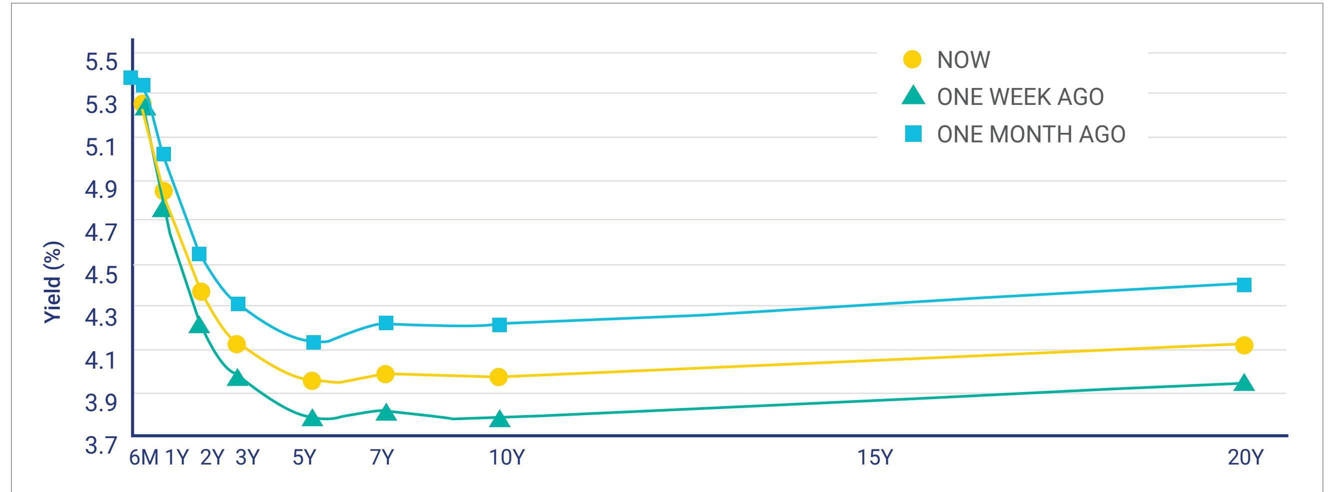
The technology sector was 2023's shining star, with returns of 57.8% for the sector as "AI mania" drove the "Magnificent 7" stocks, and the rest of the sector, higher. Will tech's dominance in equity markets' returns continue in 2024, or have stock prices moved too high too fast? To attempt an answer, we'd point out a few things. First, the tech sector is currently 28% of the S&P 500. Microsoft and Apple alone account for over 44% of the tech sector (Source: FactSet 01/08/2024). More importantly, technology is infused into every corner of the global economy. Innovation in the 21st century occurs due to technological advancements. And now, artificial intelligence offers the promise of advanced innovation. These days it feels as though the simple mention of AI in a company's process, regardless of industry or sector, is a requirement if a CEO wants to be seen as forward-thinking. As investors, we acknowledge that stock prices for many tech sector darlings are quite high relative to expected earnings. So, caution against piling into the high-flying tech names is advised. However, the likelihood is that other sectors benefit from technological advancement (including AI) and begin to participate over the next few years.

As the current post-COVID-related economic hiccups fade into history, we believe that market breadth widens as the economy stabilizes. As a result, some of the traditional "value" sectors like Financials and Health Care, which are significantly undervalued compared to the rest of the market, will likely "join the party" in 2024.

Fixed Income Portfolio Positioning:

The market has been paying particularly close attention to treasury yields for the last several months. It has, indeed, been a wild ride for treasuries. In early April 2023, the 10-year treasury was at a yield of 3.29%. It was still sub-4% (at 3.75%) in late July. It then rocketed all the way up to 5% in late October before falling back to the 4.0% level it sits at now (Source: all citations from FactSet as of date noted).

US Treasury Yield Curve



Source: US Department of the Treasury/FactSet. As of 1/4/2024

This movement has led to significant volatility for a portion of the portfolio that is expected to provide "Sleep Well Money." Longer-dated bonds are expected to provide a "hedge" to equities—but this relationship has been broken going back to the beginning of 2023, and there has actually been a tremendously high correlation between the 10-year treasury and US Equities. What that means is that as bond yields fall, equities rise. Conversely, when bond yields rise, equities have fallen.

For this reason, we have maintained a short duration stance in fixed income portfolios. We have had this tactical positioning for some time, and despite the occasional month or two where long bonds rallied, for the most part it has paid off handsomely for our clients. Long bonds are simply not providing the equity hedge that they traditionally do. What's more, the yield curve remains inverted, so short maturities continue to yield more than long maturities. This all adds up to a fixed-income environment where we are more comfortable taking the higher yields and lower volatility offered by shorter-term bonds. As with any tactical decision, we don't expect this positioning to hold forever but we are confident in it for the time being.

Conclusion

We are calling 2024 "The Year of the Pivot" to describe the importance of Fed policy in adjusting from a strategy designed to slow inflation to a strategy intended to avoid recession. It has been hard to argue with Fed policy management since COVID began, as their rate cuts kept a fragile economy afloat. That may have been the easy part. As GDP growth defies higher interest rates at present, the Fed may be forced to keep rates higher for longer than anticipated. The impact on financial markets will likely be increased volatility, if not a recession. The Fed will continue to "read the tea leaves" and adjust accordingly. Caution is warranted in the near term, with the longer-term outlook becoming more bullish as we move further into the year.

As always, please don't hesitate to reach out to your contacts at Webster Private Bank if you have any questions. It is a pleasure to serve you during these difficult times and we appreciate the trust you have placed in us.

[1]Source: FactSet 10/27/2023 through 12/31/2023;
[2]Source: All Capital Markets returns from Morningstar as noted, through 12/31/2023

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