TREASURY | PARTNERS

2023 Review & 2024 Outlook

Did the Fed Really Tighten?

January 12, 2024

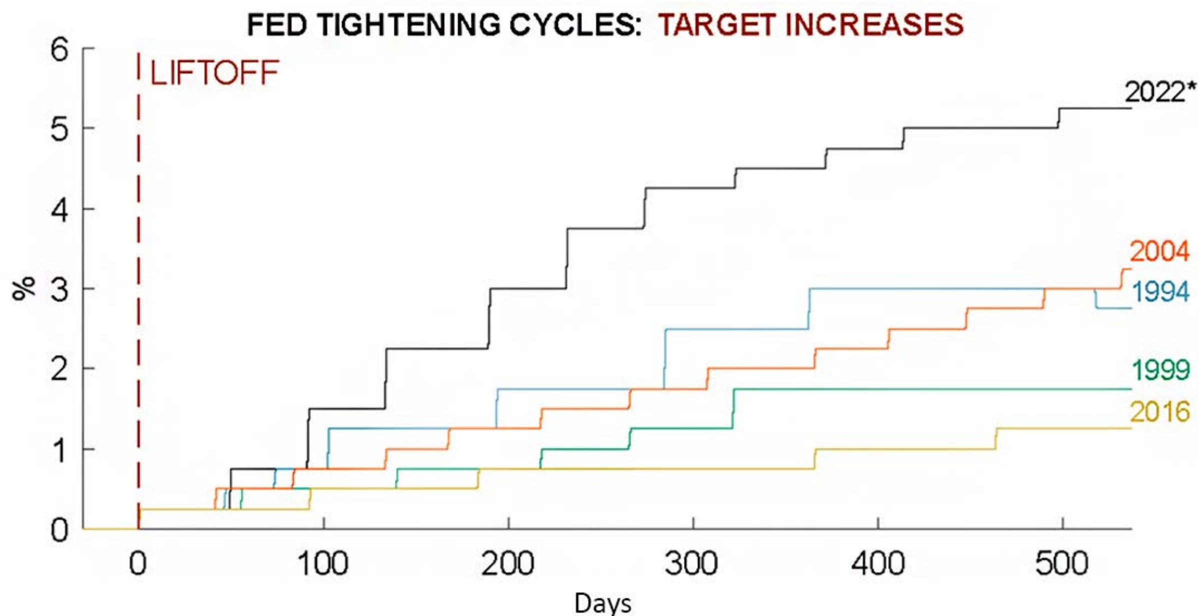
Intro

Volatility carried over from 2022 into 2023, as equity and bond markets reacted to Fed activity. But in the end, investors were rewarded with strong returns on risk assets. Does 2024 promise to be more of the same? Read on for our thoughts on how to position for the year ahead.

2023 Review

To sum up the major takeaways from 2023, one big-picture theme stands out: both the real economy and markets held up remarkably well despite the countervailing pressure of elevated interest rates, a hawkish Federal Reserve, and a flurry of steadily weakening economic indicators.

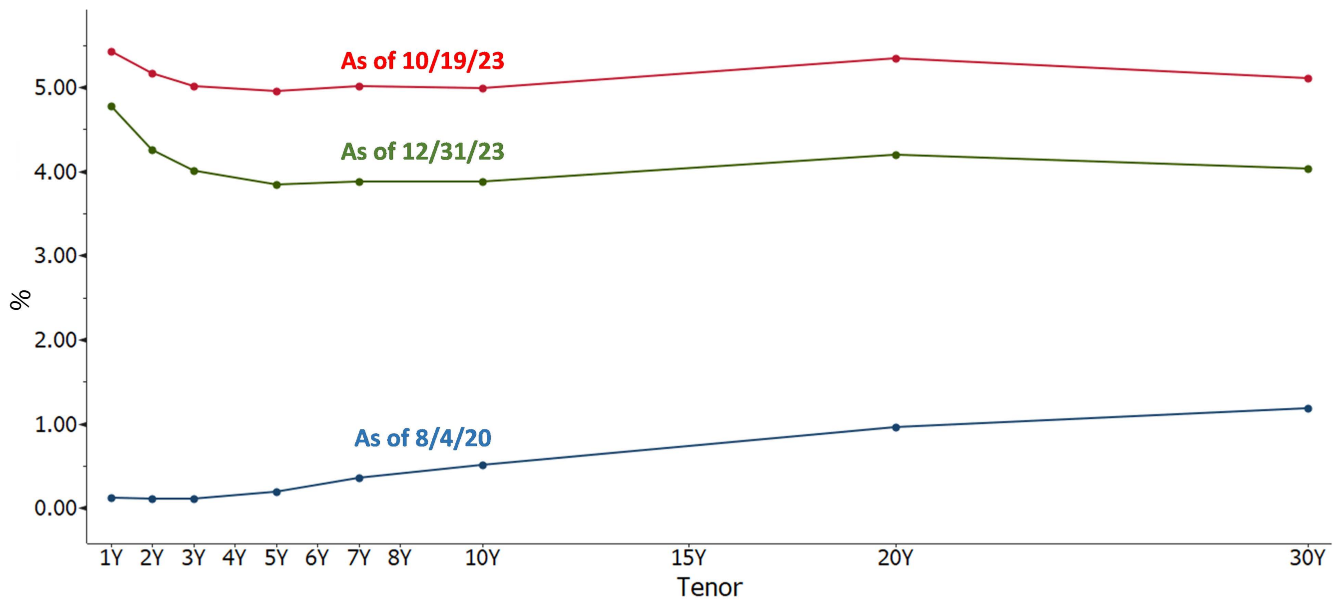
After more than a decade of ultra-easy monetary policy that helped spark a generational surge in inflation, in 2022 the Fed kicked off the most aggressive rate hike cycle in a generation, along with a steady stream of Quantitative Tightening (QT) to boot.



Source: Piper Sandler Macroeconomic Research, as of 9/4/23

As a result, interest rates across the curve rocketed higher by 450-500 basis points (4.50-5.00%) from their summer 2020 all-time lows to an October 2023 peak. Although a major year-end bond market rally has since driven long-term yields lower by 100+ bps, it's still a massive increase from where rates sat just a couple of years ago.

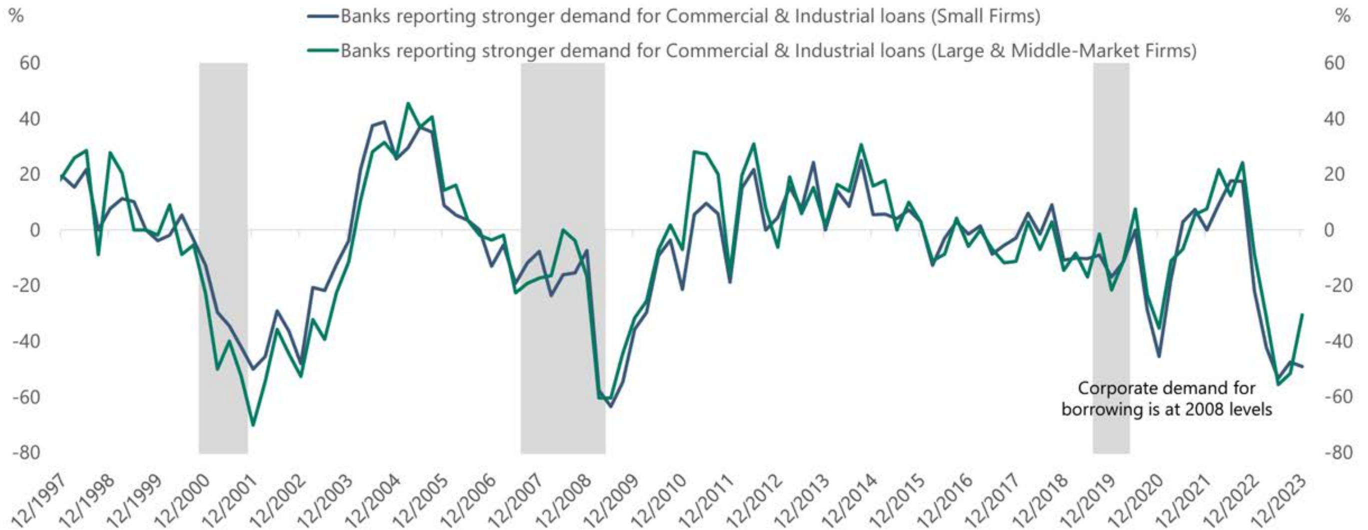
US Treasury Yields



Source: Bloomberg, as of dates shown

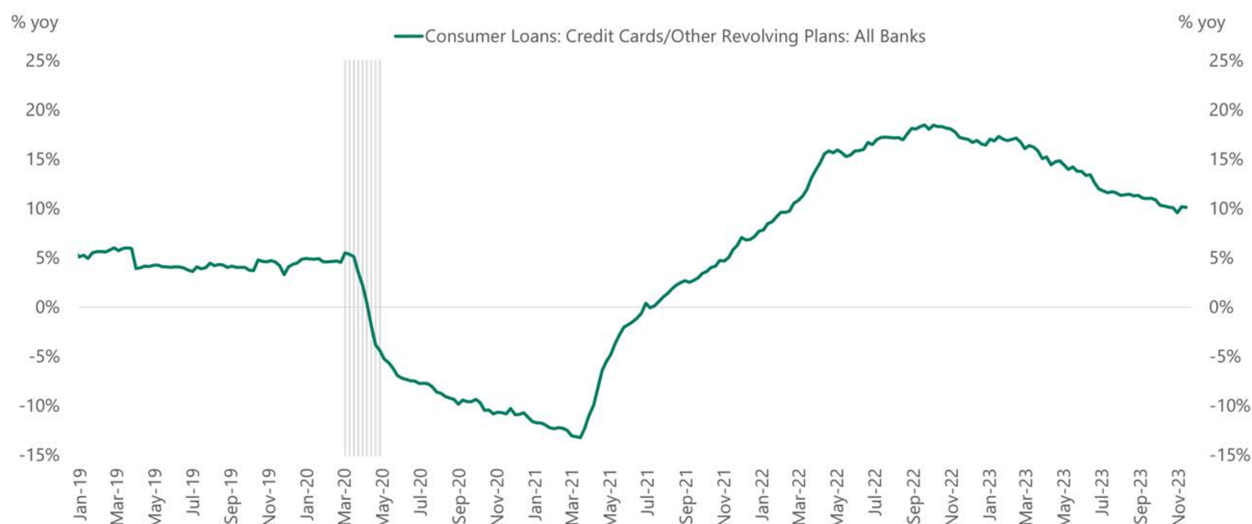
Higher benchmark rates typically act as a drag on economic growth: increasing loan costs lead to less borrowing by both companies (fewer capex investments) and consumers (lower spending). We're already seeing mounting evidence of both dynamics in effect.

Demand for corporate loans is at 2008 levels



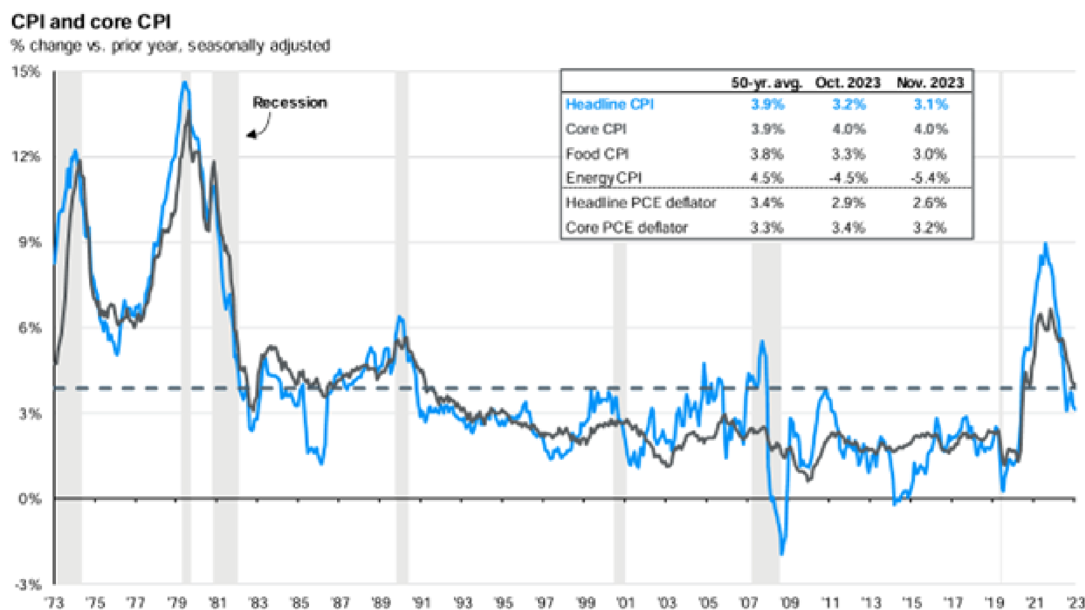
Source: "Outlook for the US Banking Sector", Apollo Global Management/Torsten Slok, 12/4/23

Decline in growth in credit card lending



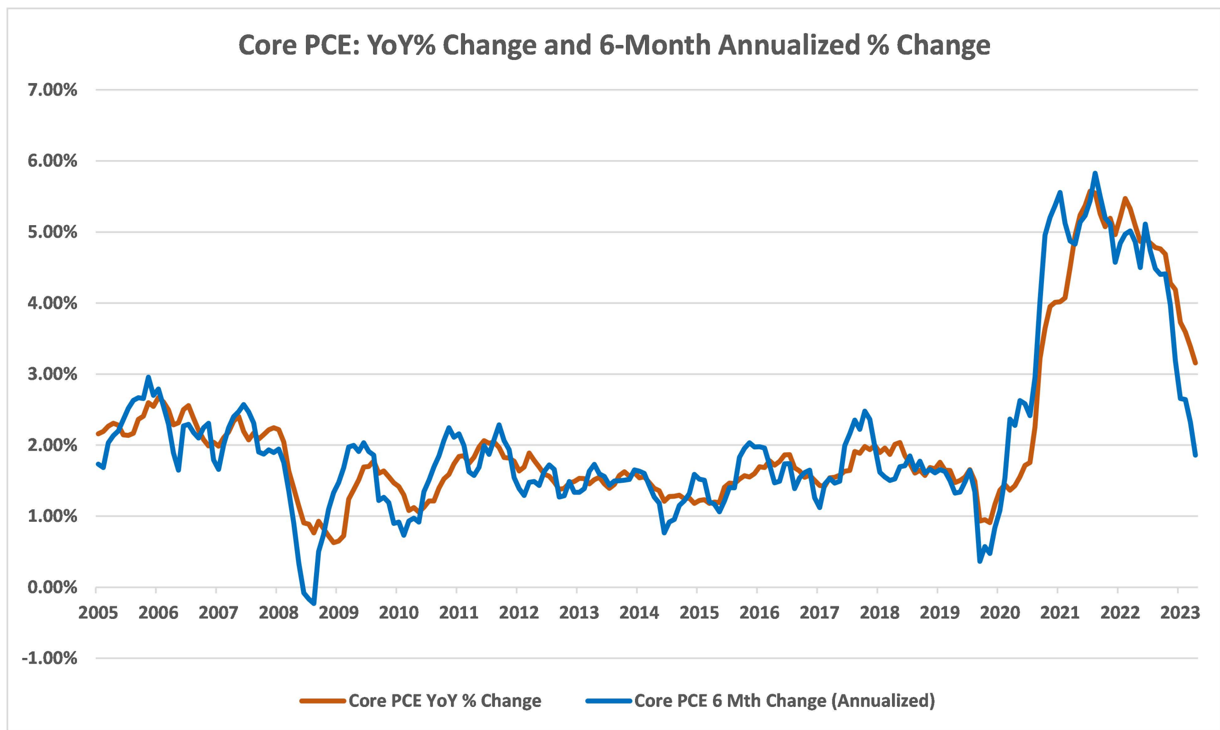
Source: "Outlook for the US Banking Sector", Apollo Global Management/Torsten Slok, 12/4/23

Of course, this is an intended outcome, as the Fed seeks to suppress inflation. But there's real risk that if they misjudge the situation and overtighten, the economy will instead swing past mere 'slowing' and instead help tip the economy into outright recession. As of now the more benign 'Goldilocks' scenario is still in play: inflation has cooled considerably while the economy has proven surprisingly resilient.



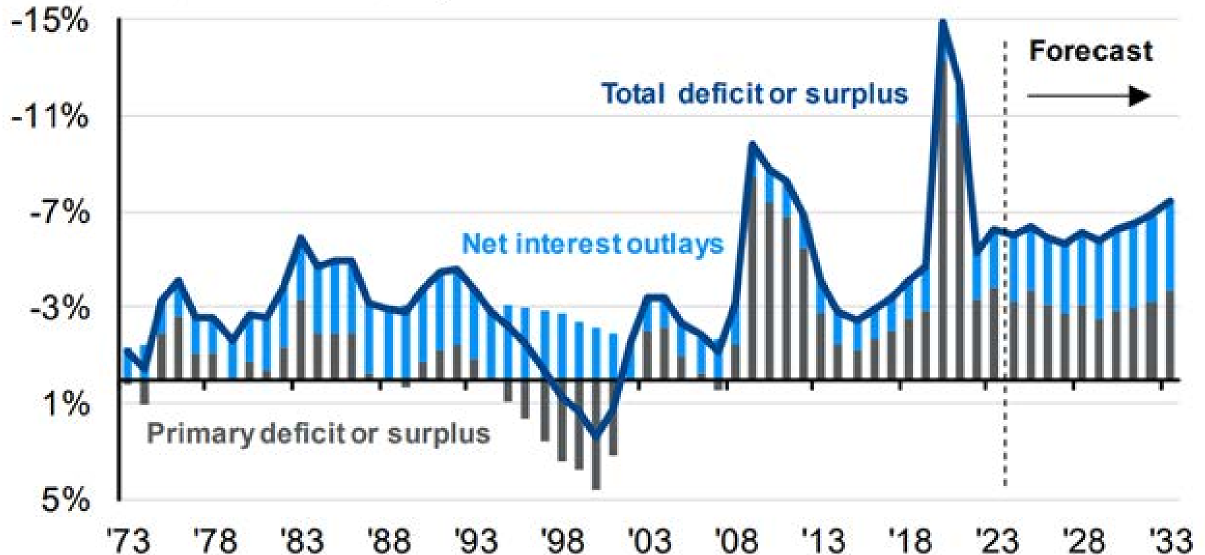
Source: JPMorgan "Guide to the Markets", as of 12/31/23

We continue to expect further improvement in the inflation data. Using the 6-month annualized rate of change shows underlying inflation is already trending within hailing distance of the Fed's 2% target.



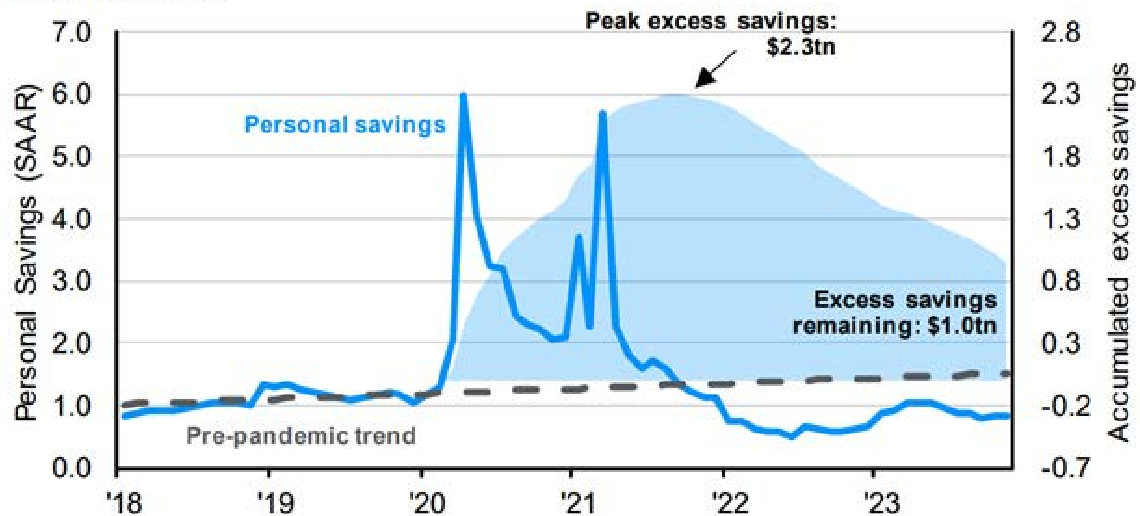
Source: Treasury Partners/FactSet, as of 12/31/23

One big reason why the economy has kept chugging along is that tight monetary policy has been roughly counterbalanced by easy fiscal policy; copious federal spending and fiscal transfers have been financed by deficits larger than anything we've seen outside of wartime and periods of financial crises.



Source: JPMorgan "Guide to the Markets", as of 12/31/23

Additionally, despite the inflationary surge it appears households still aren't quite finished spending down their accumulated excess savings from the COVID era. It means the American consumer, the engine powering our economy, still has more levers left to pull.



Source: JPMorgan "Guide to the Markets", as of 12/31/23

The unexpectedly benign backdrop has greatly supported equities, with the major domestic indices posting strong headline returns in both absolute terms and relative to their global counterparts.

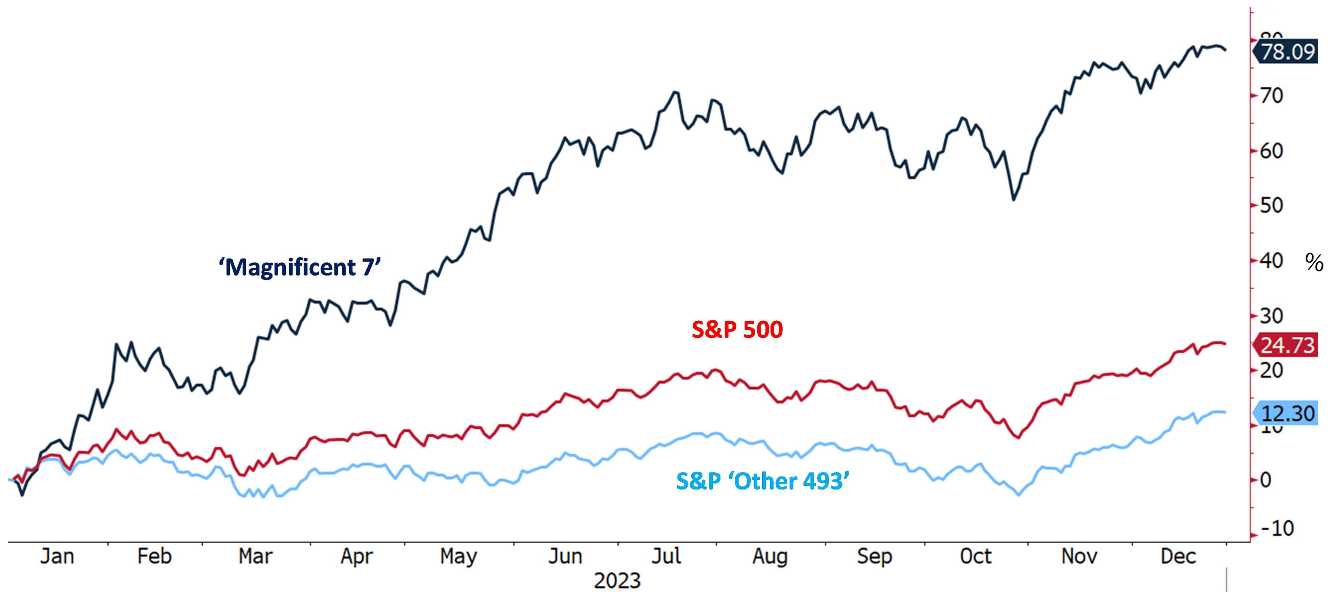
Selected Equity Index Total Returns

Index	Price Return
S&P 500 *(Large Caps)*	**+26.3%**
Russell 2000 *(Small Caps)*	**+16.9%**
Nasdaq *(Tech)*	**+44.7%**
MSCI World ex US *(International)*	**+16.2%**
MSCI Emerging Markets *(International)*	**+10.1%**

Source: Bloomberg, as of 12/31/23 (assumes dividends are reinvested in index)

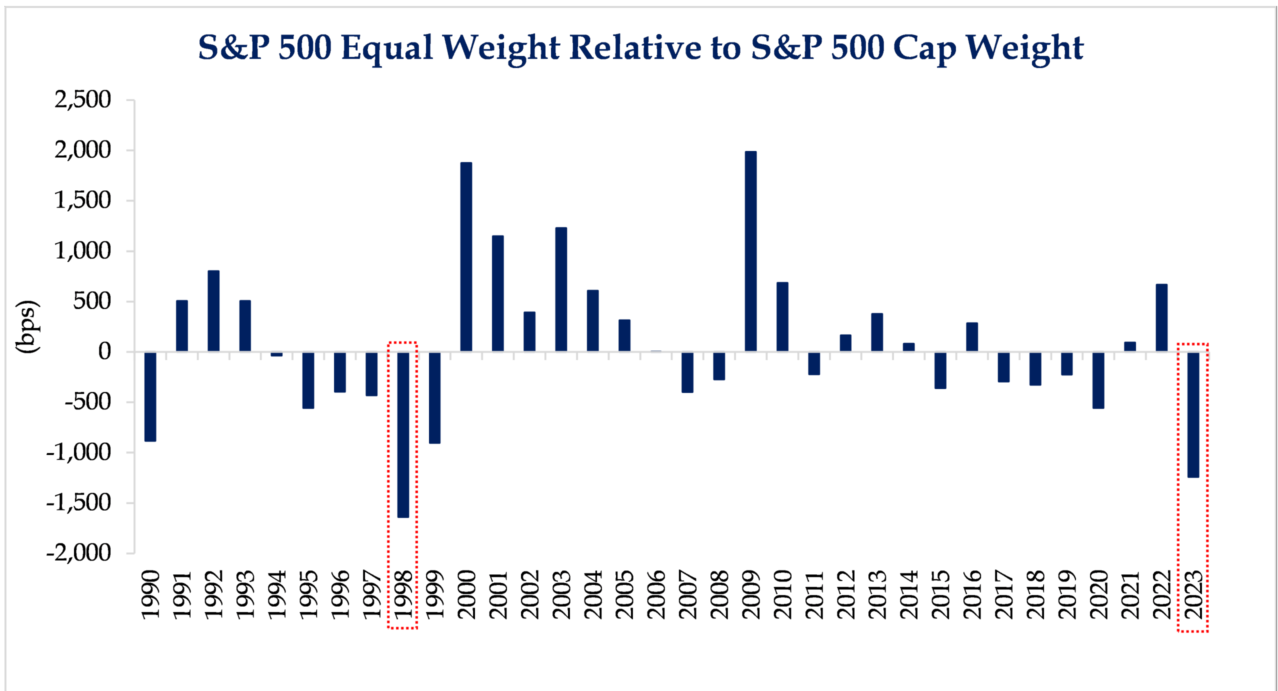
But there's an even more nuanced story underneath the hood - notice the wide divergence within the S&P 500 between the 7 largest stocks (aka: the 'Magnificent Seven' comprising Apple, Microsoft, Alphabet, Amazon, Meta, Tesla, and Nvidia) and the 'other' 493 stocks.

S&P 500 2023 YTD Price Returns



Source: Bloomberg, as of 12/31/23

The 'Mag 7' was clearly responsible for the vast majority of the market's growth in 2023. In this winner-take-all market, it wasn't even a close contest: the relative performance of the equal-weight S&P 500 vs. the headline cap-weighted S&P 500 was the worst since 1998.



Source: Strategas, as of 12/31/23

Ultimately, this means that equities are closing out 2023 with P/E multiples that are noticeably elevated vs. historical norms. If Fed tightening continues to dull economic activity, that means there's little cushion left in multiples to absorb the accompanying pressure on corporate profits.

Valuation measure	Description	Latest	30-year avg.*	Std. dev. over/under-valued
P/E	Forward P/E	19.51x	16.59x	0.90
CAPE	Shiller's P/E	32.43x	27.55x	0.79
Div. Yield	Dividend yield	1.54%	2.00%	1.33
P/B	Price to book	3.97x	3.11x	1.10
P/CF	Price to cash flow	14.82x	11.13x	1.64
EY Spread	EY minus Baa yield	-0.33%	0.04%	0.20

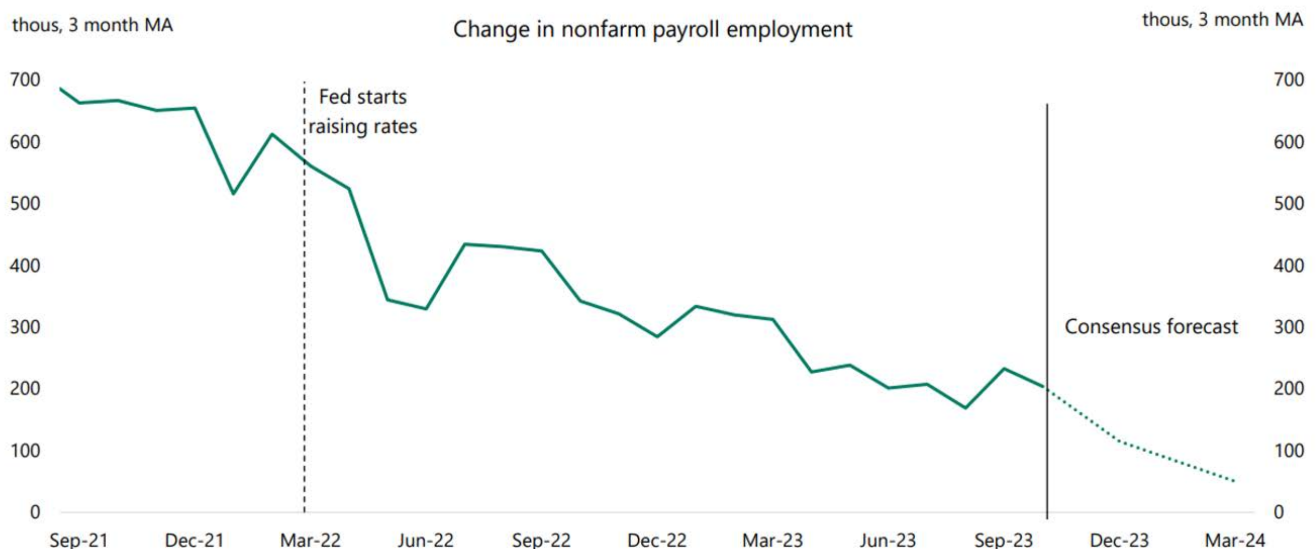
Source: JPMorgan Guide to the Markets, 12/31/23

2024 Outlook

Real Economy

For some time now, we've pointed out that underlying real economic conditions are weakening. For example:

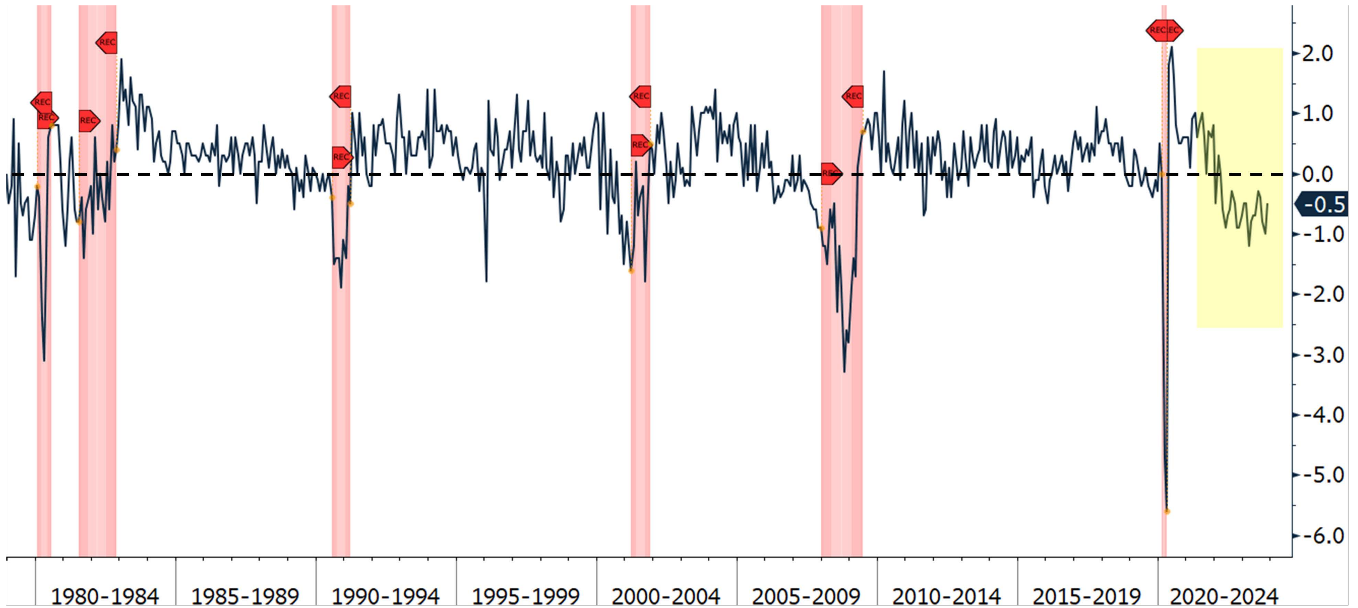
- Employment growth continues to slow.



Source: "12/5/23 Daily Spark - Labor Demand Softening", Apollo Global Management/Torsten Slok, 12/5/23

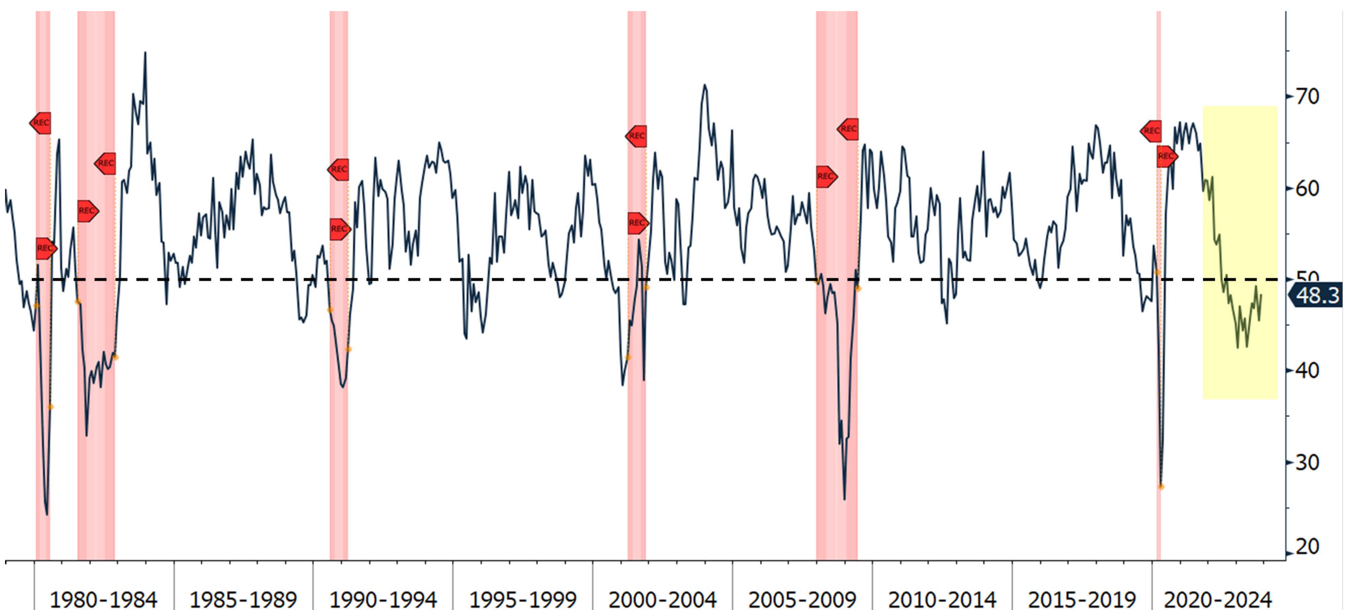
- The Leading Economic Indicators (LEIs) and the ISM New Orders indices both remain stuck well within negative territory. Remember: the LEIs have a fairly good track record of forecasting recessions, while New Orders numbers below 50 indicate corporate purchasing managers are continuing to downshift corporate spending activity. (Note: in any of the following charts, pink shading indicates past recessions).

Conference Board US Leading Economic Indicators Index



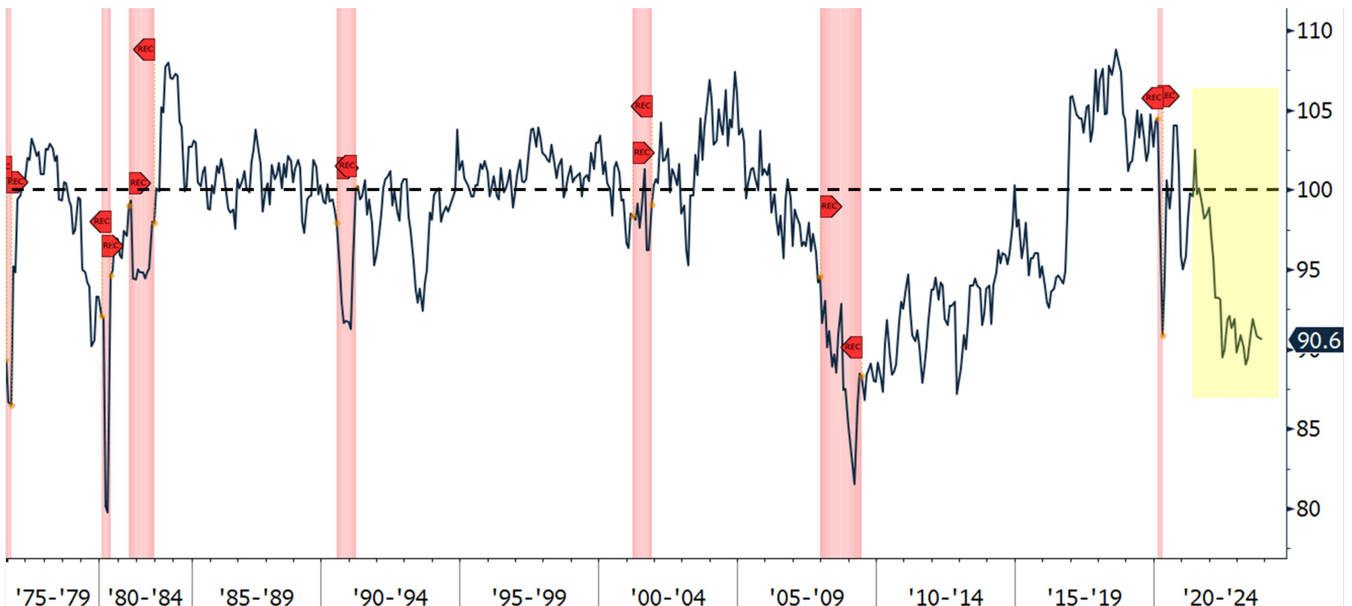
Source: Bloomberg, as of 12/31/23

ISM New Orders Index



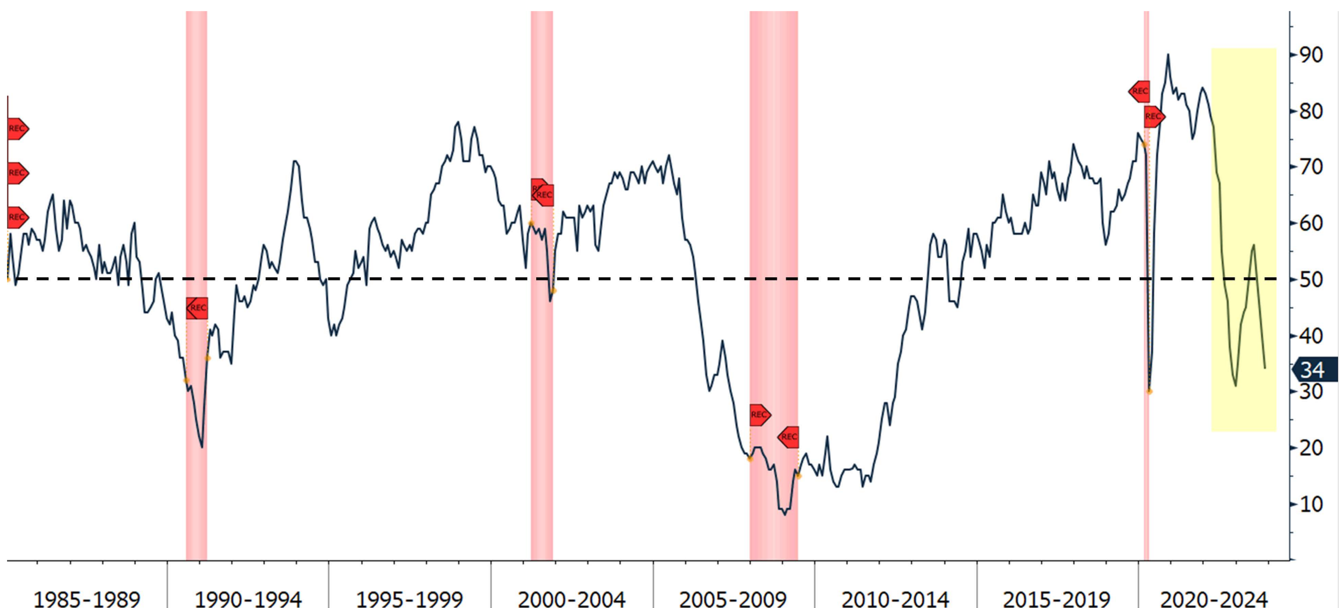
Source: Bloomberg, as of 12/31/23

- Speaking of corporate behavior, small business owners (responsible for employing two-thirds of Americans) are still feeling pessimistic about their future prospects.



Source: Bloomberg, as of 12/31/23

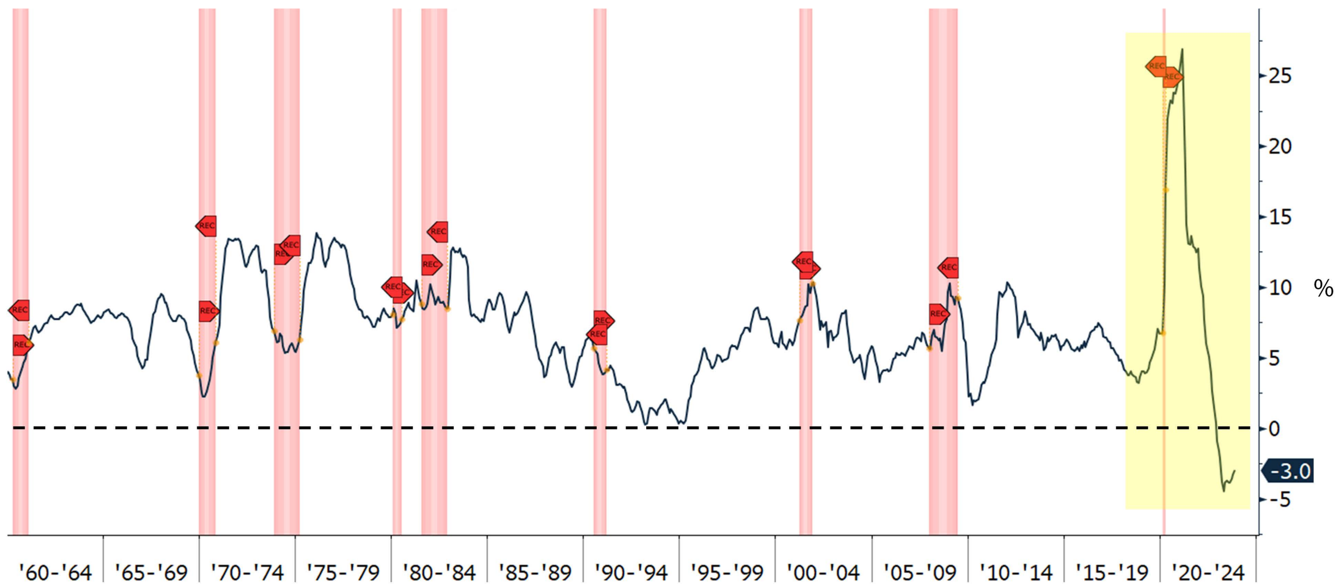
- Housing, a critical sector with far-reaching influence, is struggling.



Source: Bloomberg, as of 12/31/23

- All of this traces back to the drastic changes in the monetary backdrop, which influences both major and minor spending decisions across industries. It's unprecedented to witness just how much has changed in the past couple of years, where we've whipsawed from the largest liquidity infusion in history to the most abrupt withdrawal of the punchbowl ever witnessed.

YoY Percentage Change in M2 Money Supply



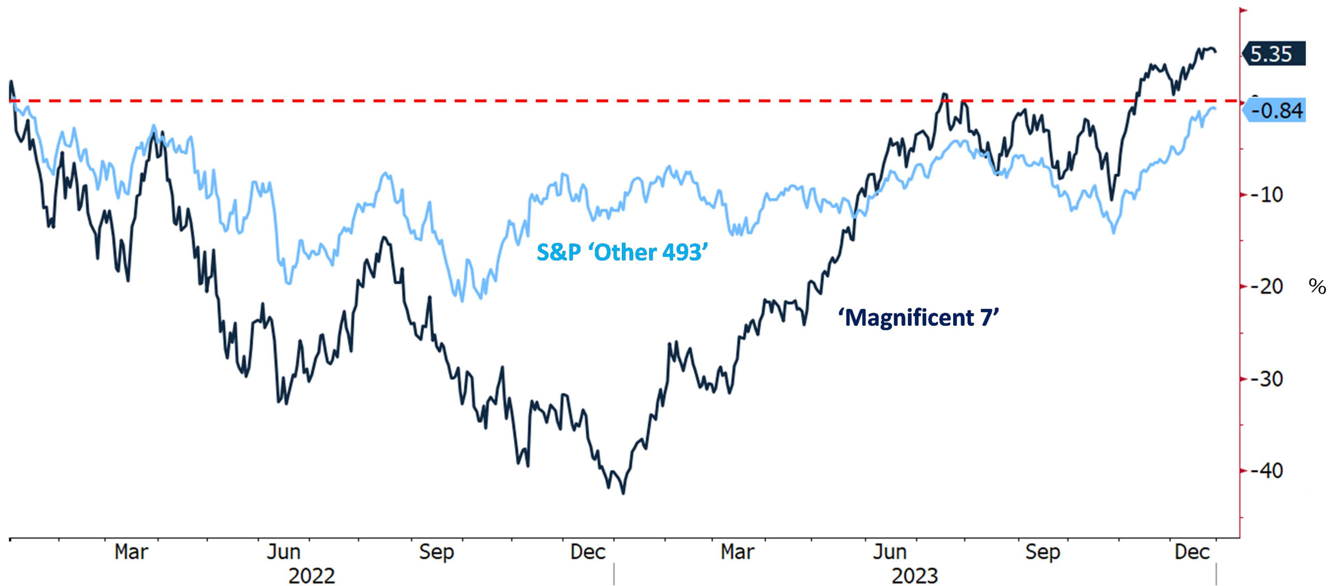
Source: Bloomberg, as of 12/31/23

Remember that fundamentals aren't necessarily near-term drivers of markets - after all, 2023 proved excellent for risk-assets despite these economic conditions persisting all year. But over the long run, they're far more likely to have impact. *We suspect that, at least for now, the long lags between the Fed's tightening campaign and its associated economic impact are being stretched out over a longer period than usual because of the lingering support from continued drawdowns of 2020-2021's unprecedented liquidity injections. But sooner or later, that will come to an end.*

Equities

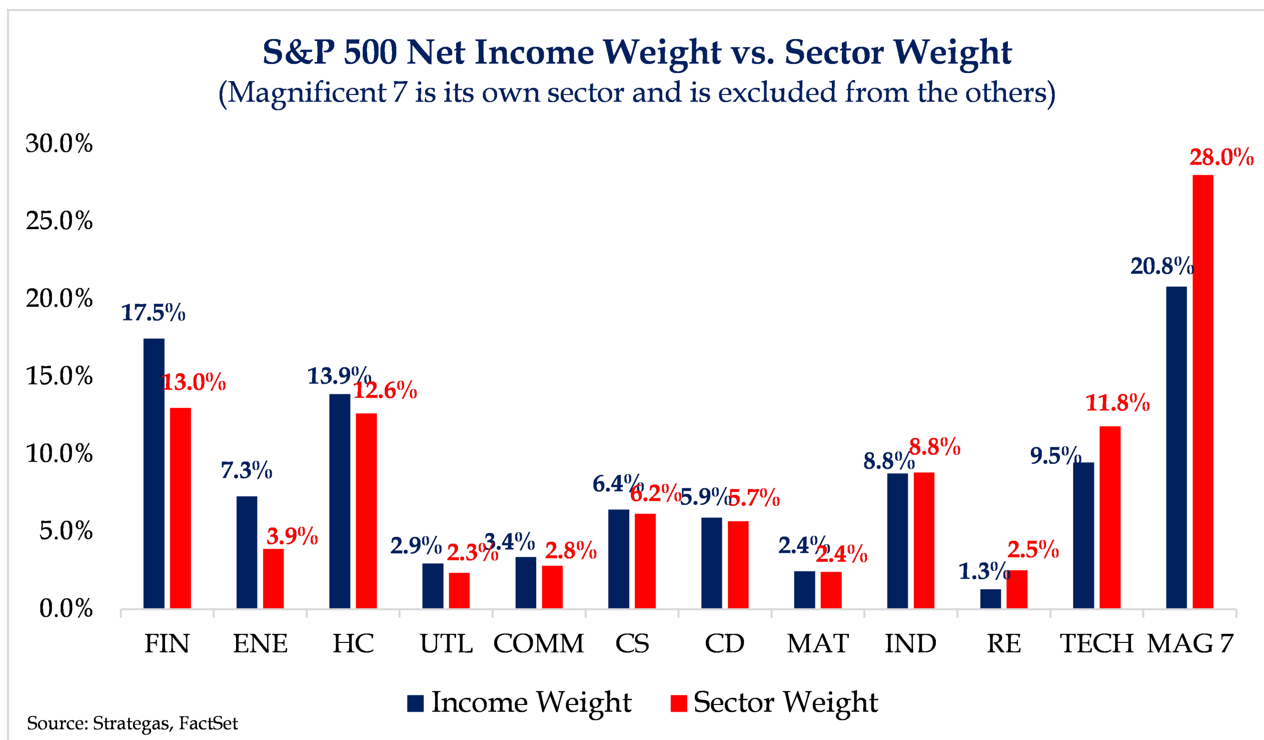
Here's a surprising fact: if you exclude the Magnificent 7, collectively the other 493 stocks in the S&P 500 have been in a 2-year bear market. The two-year cumulative return has been just about unchanged. To state that market breadth has been 'lacking' is a real understatement.

S&P 500 Price Returns Since 2021



Source: Bloomberg, as of 12/31/23

Although the Mag 7's performance carried the index for most of 2023, in Q4 the performance metrics started to broaden out. This is a positive sign for valuation, but nonetheless a lot of optimism has already been baked into the current market pricing. When considered as a standalone sector, the Mag 7's index weight is approximately 29% while from an earnings perspective these 7 stocks only generate 17% of the S&P 500's aggregate earnings.



Source: Strategas/FactSet (As of 12/31/23)

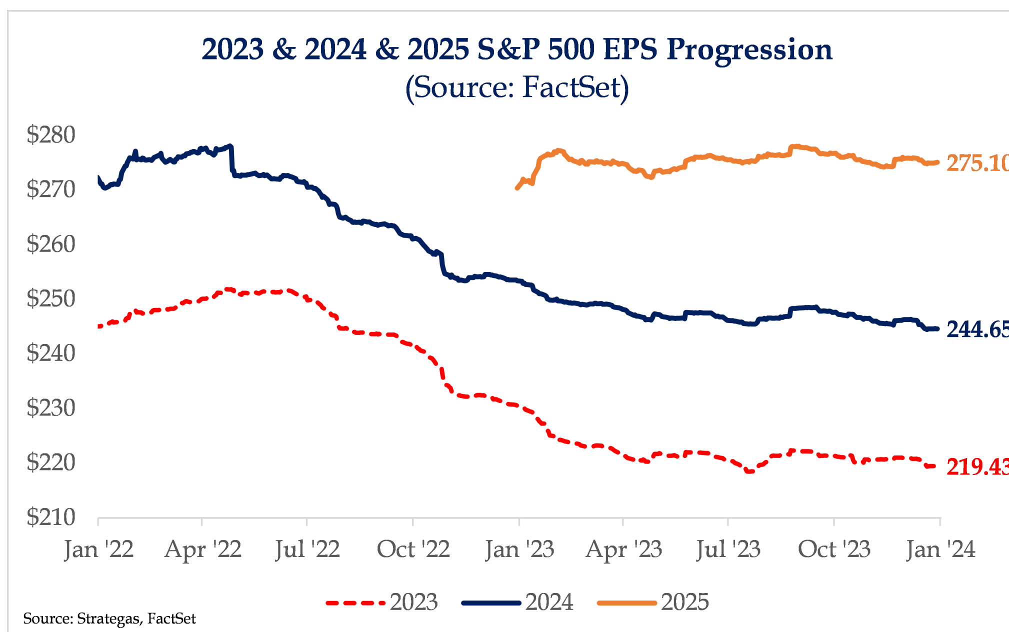
The prospect of a future bonanza from Artificial Intelligence-related technological advances has driven investor interest in these stocks to lofty levels. The P/Es on these index-driving names are at levels reminiscent of some of the most vicious equity bubbles of modern times. But as long-time readers know, we like the long-term prospects of large cap technology as many of these companies enjoy strong levels of (growing) recurring cash flow, wide moats around their businesses, and innovative technologies that in many cases are unmatched by competitors. As an example, Alphabet's (GOOG) FY 2019 operating cash flow was $54 billion. By 2023, this amount had nearly doubled to $106b. While multiples will ebb and flow, their core business continues to grow, benefiting investors over the long term.

S&P7 stocks are as overvalued as the Nifty Fifty and tech in 2000

S&P7	Trailing P/E	Tech bubble	March 2000 P/E	Nifty Fifty	1972 P/E
Meta	22	Intel	41	Coca-Cola	46
Amazon	68	Cisco	100	McDonald's	71
Apple	31	Dell	57	Texas Instruments	40
Google	25	Microsoft	51	IBM	36
Microsoft	36			Xerox	46
Nvidia	115			Polaroid	95
Tesla	75				
Average P/E ratio	**53**	**Average P/E ratio**	**62**	**Average P/E ratio**	**56**

Source: "11/27/23 Daily Spark – AI Is the Latest Shiny New Toy", Apollo Global Management/Torsten Slok, 11/27/23

Speaking of earnings: while 2023 EPS figures declined as the year progressed (as stocks simultaneously rocketed higher), today's consensus estimates for 2024 and 2025 nonetheless assume robust annual increases of +11% and +12%, respectively. That's an optimistic forecast given the current level of high interest rates.

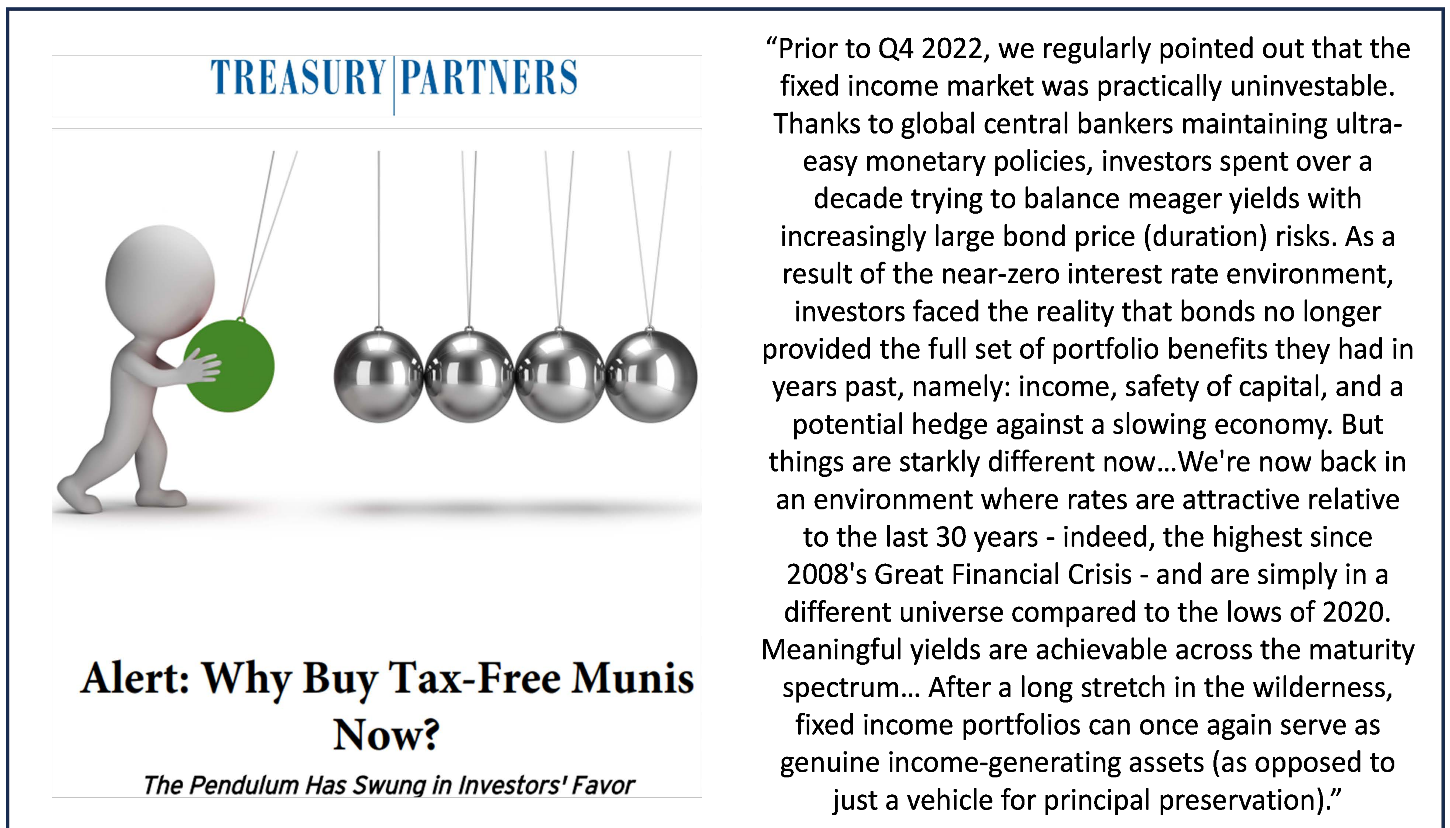


Source: Strategas/FactSet (As of 12/31/23)

Even taking these estimates as a given, at the S&P 500's current 4,750 level that pencils out to implied >19x forward P/E multiple, a very generous value. However, historical multiple comparisons must be adjusted to reflect the fact that today, the Mag 7 carry much higher multiples and market share.

Fixed Income

After a decade-long drought in yields, the last few months of 2022 gave us a fleeting taste of an investable bond market. Happily, 2023 proved to finally be the year when the opportunity to lock-in genuinely meaningful yields on fixed income portfolios became achievable once again. As we wrote barely 2 months ago:



Source: "Alert: Why Buy Tax-Free Munis Now? The Pendulum Has Swung in Investors' Favor," Treasury Partners, 11/7/23

As clients know, we spent most of the year aggressively adding long-maturity municipal (and where appropriate, corporate) bonds to client portfolios, typically capturing tax-free yields upwards of 4% when market conditions permitted. Our market call was and remains clear: Fed tightening will eventually lead to lower rates. As you've undoubtedly heard us say time and again, our experience in past cycles is that rates typically 'take the stairway up but the elevator down;' That's exactly what's happened since early November when in the final 2 months of the year, ten-year yields plunged by nearly 120 basis points (1.20%).

“The decision to extend maturities isn't one we've made lightly. All else equal, extending means accepting more duration (or price) risk - if rates continue rising, longer-dated bonds will generate higher price losses than those with shorter maturities (and vice versa)...

Source: "Alert: Why Buy Tax-Free Munis Now? The Pendulum Has Swung in Investors' Favor," Treasury Partners, 11/7/23

There are times when it makes sense to extend maturities, and times when it's not so appealing. With rates having retreated from their highs, we're dialing down the degree to which we're repositioning portfolios. But, as always, we stand ready to act (aggressively) if and when the window for higher rates opens once more.

Treasury Partners View

The return of an investable bond market meant we spent much of 2023 taking advantage of the opportunity to adjust client asset allocations to add long-term bonds. This strategic shift enabled us to reduce exposures to other potentially riskier (and often less liquid) asset classes such as alternative investments.

Simply put, we're thrilled to have done so. It represents a return to a more 'normal' asset allocation strategy for our clients and their families, where the overarching priority is to conservatively grow generational wealth.

Looking ahead, there are more competing crosscurrents than usual to be considered, any of which could drive *near-term* risk-asset returns in either direction:

- With inflation moderating and the Fed signaling the increasing possibility of rate cuts, the brightening monetary backdrop could help bias equities higher. In such an optimistic scenario we'd expect a major theme to be a further broadening-out rally for the ‘Other 493' stocks that have largely been left behind in favor of the crowded 'Magnificent 7.'
- However, at some point weaker fundamentals will matter, and elevated earnings expectations for 2024 and 2025 could become an anchor on equity market performance as a result of the lagged impact from the Fed's tightening campaign.

That doesn't mean we've totally retreated from allocating to stocks – quite the opposite. As we've written before, we remain committed long-term equity investors:

Long-Term Bulls

"While we're short-term cautious, stocks have long been key drivers for amassing wealth. Our amazing economy is constantly bursting with innovation and entrepreneurship, the financial benefits of which ultimately end up flowing to equity investors.

For those long-term equity investors who have stayed the oft-volatile course, the results are clear:

- Over the last 20 years, the S&P 500's earnings are up 290% from $55 to $215/share. The index's price has risen over 340% over that time
- Over the last 10 years, earnings are up 95% from $110/share and the index's price has risen by 165%
- Over the last 5 years, S&P earnings are up 35% from $160/share and the index's price has risen by over 80%

While stock prices and valuations will constantly change, in the long run, they represent the best way to participate in the US economic engine.

Source: "2022 Review and 2023 Outlook," Treasury Partners, 12/20/22. Historical return figures recalculated for rolling periods as of 12/31/23

Happy Holidays

Each day, I continue to look forward to my daily work, and the entire Treasury Partners team shares that same passion. We therefore are immensely grateful for the trust and confidence you place in us. It's a great honor to manage your assets and we will continue to work hard to earn that trust.

On behalf of our entire team, we'd like to offer our best wishes for a happy and healthy 2024.

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BARRON'S ADVISOR Top 100 Financial Advisors 2023

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