

Q4 • 2023

Capital Market Outlook

The stock market, as defined by the S&P 500, rallied 11.7% in Q4 and 26.3% in 2023, one of the better quarterly and annual returns in the index's history. The strong return was driven by falling inflation and expectations the Fed will cut interest rates in 2024. While the first half of the year was dominated by the rise of the "Magnificent 7" mega-cap stocks, Q4 saw market breadth improve, with small caps and cyclicals contributing to gains. Though valuations are moderately higher after the strong rally, we believe the market is positioned for continued growth in the long term, even considering the possibility of an economic slowdown in 2024. Our focus remains on identifying and investing in companies with strong fundamentals and long-term potential.

The market rally gained steam in mid-November, following the release of consumer-price-index (CPI) data for October showing that inflation is easing back down towards the Fed's 2% target. Core CPI rose 4% y/y, below the 4.1% estimate. Shelter (housing) declined, which had remained stubbornly high, while core goods fell for the fifth consecutive month. Cooling inflation essentially eliminated the possibility of additional Fed hikes and shifted the consensus to near-term rate cuts from the Fed. Stock indices surged that day as a result, with the S&P 500 up close to 2% on the day of the CPI release and small caps (as defined by the Russell 2000) delivering a historic 5.5% one-day return. Core CPI was up 4% again in November and 3.9% in December, although the December read was above the 3.8% estimate and thus created some questions about the urgent need for rate cuts.

The Fed held rates steady at both its November and December meetings. However, there was a notable and important change in tone from Fed Chair Powell in December, who recognized progress in the fight against inflation. The Fed also forecasted 75bps of rate cuts in 2024, which helped propel a "Santa Claus rally" through the holidays and into the end of the year. Investors are now expecting close to an 80% chance of a rate cut at the Fed's March meeting, and are expecting six total rate cuts this year, compared to the Fed's own expectation for three rate cuts. The Fed has signaled that it doesn't want to appear political by cutting rates during an election cycle, which could mean the window for rate cuts is fairly narrow in the first half of 2024.

Meanwhile, the economy has remained resilient, leading many investors to conclude that the Fed has in fact orchestrated a "soft landing". The economy continues to add jobs (216k in December), and wage growth remains strong but has cooled from last year. Q3 GDP came in at 4.9%, while Q4 GDP is expected to slow to 1.4%. Retail spending has held up so far with the initial read on the holiday season generally positive at around 3% growth over 2022. Corporate earnings have generally been better-than-feared, although many CEOs have called for slowing growth in 2024 and the upcoming earnings season will be key to set expectations for the year. S&P 500 earnings are expected to grow 10% in 2024, following a modest decline in 2023. While achieving this even under a "soft landing" scenario seems aggressive to us, it's not out of reach. Potential margin expansion in certain sectors could offset the expected slowdown in overall growth.

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The economy appears to still be growing, but many measures have slowed significantly and are at levels of previous recessions. ISM Manufacturing has been in contraction territory for 14 months, and the bigger piece of the economy, ISM Services, is teetering on contraction. The jobs data has been good but has been revised lower with each report for every month in 2023 except one, and the household survey portion of jobs data was very weak in December. Leading Economic Indicators have been weak for 16 months, suggesting a recession is imminent, which is echoed by the inversion of the yield curve. Geopolitical risks remain, such as military conflicts and disruptions to trade, not to mention a likely contentious election cycle. With the economy slowing, the Fed will need to cut rates aggressively to re-stimulate the economy in our view.

Looking forward, we believe equities remain the best place to invest for long-term capital appreciation. However, we do see some near-term risk as a “soft landing” appears fully baked into market expectations. Consensus seems to be that the economy will continue to grow with inflation moving back towards the Fed’s 2% goal. But the economic data being cited as proof the economy can weather the Fed’s hikes is all backward-looking, and prior Fed rate hikes are still filtering into the economy today. If the Fed cuts rates before there is any sign of material economic weakness, the stock market may have room to continue the rally; however, a cut in response to weak data has historically led to a selloff.

At AMI, we continue to invest for the long term with portfolios consisting of high-quality businesses that we believe can grow revenue and earnings in all economic backdrops. We believe we are well positioned for any potential weakness with some balance should the economy reaccelerate.

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