TRANSCRIPT: Q4 2023 Market Update

This is a transcript of a video created on January 19, 2024. Visit our YouTube Channel to view this video at https://youtu.be/mvmWpi9Uudo or our website at www.levelFA.com

Hello, everyone. This is Steve Elwell, the Chief Investment Officer of Level Financial Advisors, and this is your 4th quarter 2023 market commentary. The stock and bond markets had a great quarter, despite a rough October. They ended with an excellent November and December, as the US stock market was up 12.07% for the quarter. International developed stocks were only a little bit behind that. Emerging markets were up close to 8%, and the leader was global real estate, with a big rebound of 15.47% gain for the 4th quarter. The bond market, both in the US and internationally, did really well in the 4th quarter as well. In fact, ultimately ended up being some of the best quarters ever. As you can see in the lower right side of this graph from this chart from Dimensional Fund Advisors, 6.82% gain for the US bond market for the 4th quarter, which was really fantastic.

We're going to talk a little bit in a minute about why is it that the stock and bond markets ended up having such an excellent quarter, but actually, as we look at the final two months of the quarter, specifically for the S&P 500, ultimately, what ended up happening in nine weeks, there was a nine-week continuous wind streak for the S&P 500 where it gained 16% in nine weeks. Like I said, I'm going to talk in a minute about what was the driver or the catalyst of that return, but ultimately, a good lesson for investors. Keep in mind what happened, July was fantastic after the debt ceiling debacle was temporarily solved, but August, September, and October were all down. I think investors really became a little tired of the investment markets at that point a little. It was a slow drudge downward, finishing with October, which was an emphasis on the downturn. I think investors were really... The average investor was feeling pretty negative about the overall stock market situation.

But then ultimately, this quick rebound that happened, starting at the end of October and going all the way through November and December to cap off the year, which ultimately turned the year into a really good year for both stocks and bonds. But from an investment perspective, the lesson is, sometimes it's true that it's darkest right before the dawn. It can be difficult to stick with the markets when it feels like they might be going nowhere or just slowly bleeding. Often, for the average investor, it can be difficult to stick out that type of be patient through that type of scenario.

But the market ended up providing another moment where seemingly out of the blue, now I won't call this one totally out of the blue because there's a good reason behind it, but a very quick pop upwards that had someone ultimately given up on the markets or decided that, "Enough is enough, I want to exit." And often, what we hear is, "I want to get out and sit on the sidelines until things look better." And that the fallacy there is number one, that someone will be able to determine in advance when things are going to start to look better. Because, of course, if you wait for things to actually look better, for you to see it look better on the news or see it look better in the stock and bond market returns, that, of course, means you're going to miss the upward swing.

As soon as the market receives positive, unexpected news, that's immediately reflected in stock and bond prices. That's what happened in November and December, unexpected good news was received, and the markets immediately priced that in. If you were someone who was on the sidelines waiting for things to look better, you missed that ride. You didn't get that upward swing, and that accounted for the majority of the year's returns. The positive returns for 2023 came from that nine-week period. So, if you were on the sidelines, you missed out on that.

So, let's jump into what ultimately was the driver of this. So here, as we look at the stories of 2023 as a nice visual from our friends at Avantis Investors, and what it ultimately is showing on the right is inflation relative to the Fed's target, the Federal Reserve Board's target. Now, the Fed's target is pretty constant. It's always 2%. Just a little bit of inflation is their long-term goal. So the Fed's target is 2%, and at the beginning, so December of 2022, you can see two different lines here on this graph. You have the consumer price index, which is widely considered inflation. What is inflation? And that's the CPI. That's what everybody really talks about when they talk about, "Where is inflation?" Then also the personal consumption expenditures, which is kind of a slightly different way of measuring inflation, more geared towards, well, what consumers actually buy.

When you look at those two visuals, those two lines on this chart, ultimately what you're seeing is, inflation at the end of December of 2022 was in the range of 5.5% to 6.5%, depending on which of these lines you're looking at. Over the course of January and February, the spring and the summer inflation started to creep down to 5%, down to 4.5%, down to 4%, as low as around 3%. Then part of the reason that the markets in August, September, and October started to go back down was because there was a slight uptick in inflation. It's not the only reason, but part of the reason, a slight uptick or plateau of inflation around 3%, 3.5%, when, of course, the Fed is still targeting 2%. So, the market's concern was that the Fed was going to have to keep raising rates to force inflation down to 2%.

Then the big catalyst that came in was, the October and November reports really came in very close to the Fed's targets. Ultimately, if that trend continues into 2024, as the annual numbers start to roll over, so you start to remove December 2022, January 2023, and February 2023. As we start to creep into 2024, it became clear that the Fed might actually reach their target if those inflation trends from October and November continue. That was a positive, unexpected surprise. Those October and November inflation numbers, and ultimately December, that we know now, those numbers came in better than expected. They came in close with the expectation that ultimately they would reflect close to the Federal Reserve Board's annual target of 2%.

It became pretty clear to the markets that this likely meant that it sort of cemented in the market's mind that the Federal Reserve was pretty much done raising interest rates. Then not only that, but the expectation is that a pivot might be occurring as we move into 2024, where not only is the Fed potentially done raising interest rates, but might actually start to turn their attention to cutting interest rates, as we've seen the job market slow down a little bit. It's still doing well, but slowed down a little bit. The economy start to slow down a little bit. Ultimately, the markets are now expecting that the Federal Reserve will not only cut interest rates in 2024, but multiple interest rate cuts happening as soon as spring, so March of 2024.

Now, we'll see whether that ultimately ends up happening, but that's a big change from wondering will the Fed continue to raise rates to then switching gears to not only will they not raise rates, but they're going to start cutting them as early as the spring. That's a big swing. So what happened because of that is, ultimately, the US 10-year Treasury bond yield went from 5% to below 4% really quickly, which caused the bond market to spike, to go up in value dramatically. That's why bonds had such a great quarter is because generally, interest rates don't usually move that fast. So you can tell that investors very quickly reflected this information and a new set of expectations for what might happen in the future. Of course, the markets are always future-looking, forward-looking. So as interest rates go down, generally, bond values go up. That's why, when the reverse happened in 2022, interest rates went up and bond values went down. That was one of the worst years on record for bonds because interest rates spiked so dramatically.

Now, the reverse happened in November and December of 2023. Interest rates dropped dramatically, and bond values spiked and went up dramatically. So number one, this is another good lesson for why you should stick with it over the short and long run, is because things can change relatively quickly when new, unexpected news comes out. But so, from that perspective, like I said, interest rate-wise, had a big change. The stock market also ended up reflecting the expectations of what would happen if interest rates were cut.

Now, interest rates where they are today or where they were at the end of the 4th quarter, which is around 5.25% to 5.5%, that is viewed as a slightly restrictive policy on the economy. That is the Federal Reserve trying to lightly tap the brakes on the economy to cool things off in terms of inflation. That's part of their dual mandate as full employment and 2% inflation. Sometimes it's pretty tough for them to thread that needle to accomplish both goals, but it appears they're pretty close to being able to do that without actually tipping the US into a recession.

Now, we'll see, people have been talking about a recession since the beginning of 2022, and it still hasn't happened yet. So we'll see whether they ultimately are going to be right or not. But if the Federal Reserve's new expectation is to stop raising rates and actually start cutting rates, that means they're going to take their foot off of the brake and let the economy move forward. If they do that, that will be a more accommodative policy for the US economy. The expectation is lower interest rates means consumers will buy more stuff because it will not cost as much to buy it. Think in terms of the housing markets, a good example. If your mortgage rate goes from 7% down to 4.5%, you can effectively buy a more expensive house and have the same monthly payment.

Same story with car loans, credit card interest rates. I mean, interest rates work their way through so many different areas of the economy that there's a big impact. So, when the Fed cuts rates, it's widely viewed that that's good news for corporate profits, corporate sales for all the stocks, and the investment markets is that people will buy more stuff. So as the Fed lowers rates, stock market went up because that was new, unexpected expectations for 2024 because it became clear that the Fed was getting pretty close to its target.

So, we have this chart from J.P. Morgan that shows how those expectations are changing for 2024 and 2025. So, this gray line represents what the federal funds rate actually was looking backwards, and it shows where it stood at the end of 2023. But now you can see two forward-looking lines. There's a blue line, which is what the Fed themselves are suggesting for 2024, 2025, and 2026, but then the green line is what the market's actually expecting for 2024, 2025, and 2026. So, you can see the Federal Reserve themselves are actually expecting to cut rates according to this from the current 5.38% down to 4.6%, which would effectively be about three rate cuts by the end of 2024. So, the Federal Reserve's saying they're going to cut rates, the market expects they're going to cut rates even 1% more than that.

Now, who's going to be right? We don't know. Nobody else knows. But the market obviously is the wisdom of the entire crowd. The Federal Reserve Board is a group of a select small amount of people who are very extremely educated in economics, the moving parts of the economy, and how interest rates will affect that. But ultimately, we will see, but both parties are suggesting that rates are going to come down quite a bit. So, you can see why stock and bond markets rejoiced as that pivot is starting to potentially take place. That actually leads us to be fairly optimistic about 2024, if that actually comes true.

Now, that's not obviously the only variable at play. There are always 1,000 different variables that are impacting what's happening with the stock and bond markets. Obviously, a fair amount of people are looking forward to simply 2024 being a major election year. Although to be straight to the point about it, generally, the markets are not so concerned that there's an election and who ultimately wins the election. So, it's not good market returns if this person wins or bad market returns if that person wins or party wins. The markets actually have been proven to do well no matter who's in control. The markets generally prefer a mixed level of control across the House, the Senate, and the White House. That's the best scenario, often from an investment standpoint. But I think anytime someone tells you that the markets will do better or worse under one party's control, or if this person wins or that person wins, you can pretty much ignore that because there's really no evidence that tells us one thing or the other. The thing that the markets tend to respond to most positively is simply that the election is over.

That sounds, maybe, a little odd, but view it this way. When the elections are over in November, the markets tend to respond positively, just simply that they have the information of, "Okay, here's going to be the parties in charge going forward, and now we don't have to worry about the election anymore or think about it anymore, and the markets will turn their attention to all the other things that matter, like interest rates and corporate earnings when it comes to how performance plays out in the future."

So, long story short, I would not let an election year drive your investment decisions because the long-term evidence is ultimately the only thing that the markets care about, that the election is over, not who actually won. So, we generally do not make any investment changes based on a prediction of one party over another winning. But from an interest rate standpoint and from that type of change that is potentially coming here in 2024, that can be viewed, in my opinion, as a tailwind for both the stock market and even more so the bond market. The evidence is quite clear that when interest rates go down, bond values tend to go up.

Now, they may go up in different amounts depending on how long-term of a bond are we talking about, is it a 1-year bond, a 10-year bond, a 30-year bond? But generally, interest rates going down is great news for the bond market, along with the current yields that those bonds are already paying, which, for many bonds, are 4% or 5%, 6% some more. So, when I think about how the investment markets may play out in 2024, I'm feeling rather optimistic, knowing that there is potentially a tailwind coming from the Federal Reserve cutting interest rates, whether it starts in the spring, the summer, or the fall. If that ends up happening, that seems to be a positive development for the investment markets. So, with that, that is the 4th quarter 2023 market commentary.

As always, if you have any questions, reach out by email or phone, or schedule a meeting with your advisor. Also, a quick reminder, as you work your way through tax season here in 2024 for filing your 2023 return, when you finish that return, please either have your accountant send us a copy or send us a copy yourselves, because that is instrumental in us being able to properly plan to not only reduce your tax bill but to make sure we're doing all the right things regarding your personal financial situation. So again, if you have any questions, feel free to reach out. With that, we'll talk to you next quarter.