4Q23 Market Overview: Risky Business

KEY TAKEAWAYS

- Though robust gains across many risk assets in 2023 came as a relief following a bleak 2022, we can't help but wonder if markets are failing to see the forest for the trees.
- Current market dynamics imply unwarranted levels of optimism about benign outcomes to the key risks facing investors, including the uncertain economic landing, ongoing fiscal profligacy and geopolitical discord.
- Last year's equity performance did nothing to recalibrate the yawning valuation gaps between investment styles and geographies, and both value and non-US stocks continue to trade at historically cheap relative valuations.
- It's likely that risk aversion will at some point be higher than it is today; we believe owning quality businesses may be the least-bad option in a such a less-than-perfect world.

As it had for much of 2023, the performance of risk assets in the fourth quarter appeared to ebb and flow with the market's expectations of Fed policy.

While the "higher for longer" sentiment that dominated the third quarter persisted into the fourth— perpetuating a selloff in Treasuries and broad weakness in stocks—optimism that a "soft landing" and series of rate cuts were just over the horizon appeared to take root in late October. The renewal of dovish sentiment, which was reinforced by macroeconomic readings and Fed rhetoric in the weeks that followed, fueled a furious rally across a wide range of assets through the balance of the year. Notably, market breadth widened in conjunction with this surge, unlike earlier rallies concentrated in a small subset of very large technology-related names. The S&P 500 Index returned 11.7% for the fourth quarter and 26.3% for the year, while the MSCI World Index returned a respective 11.4% and 23.8%.[1] Growth outpaced value during the quarter and very significantly outperformed for the year.

While market returns in 2023 were a welcome respite from a dismal 2022, the buoyant conditions entering the new year make us wonder if hope has gotten the better of substance.

1. Source: FactSet; data as of December 31, 2023.

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Mounting Risks Go Unheeded in 2023

We believe the investment environment today is rife with challenges, the escalation of which could shake markets from their apparent complacency and inspire a newfound sense of risk aversion, to the detriment of many financial assets.

For example, current market valuations suggest markets are complacent about the inevitability of a soft landing even as any sort of landing remains elusive; in our view, the risk of an adverse outcome only increases the longer the Fed circles the runway without touching down. We have long been skeptical of the central bank's ability to achieve a soft landing and remain so today. Beyond the scarcity of previous successful attempts, the continued strength of the domestic labor market makes it hard for us to envision a scenario in which wage growth spontaneously returns to a level consistent with target-level inflation absent a meaningful increase in unemployment.

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Broadly speaking, wage growth reflects two variables: the rate of change in nonfarm payrolls and their overall level. While the rate of payroll additions has moderated, the economy has continued to add jobs at a steady clip since bottoming in April 2020 and the level of payrolls as a percentage of the total population stands near a post-financial crisis high. Not surprisingly, wage growth has been far less responsive to Fed tightening than broad inflation metrics; though off its cyclical peak, the Atlanta Fed Wage Growth Tracker—at 5.2% in its latest reading—continues to reflect a pace not seen since 2001.[2] Previous episodes of wage growth at or near the current rate were reined in only when exceeded by two-year Treasury yields for a period of time; "higher for longer"—and the economic slowing and job losses likely to accompany it—may be a necessity if the labor markets don't begin to demonstrate some slack.

We're also concerned about the unsustainable fiscal trajectory of the US and other advanced economies, as public debt balances continue to swell with no sign of the spending discipline necessary to rein them in. Financial repression via unconventional monetary policies through much of this century kept interest rates artificially low and tempered interest expenses even as debt balances continued to rise, but the rollback of crisis-era monetary accommodations has altered the calculus of government borrowing. We've yet to see indications that fiscal policy will be adjusted to reflect the new math anytime soon, however. In fact, continued deficit spending by the US during 2023 served as a stimulative impulse at odds with the Fed's monetary policy goals, perhaps accounting for the economy's apparent resilience despite a surge in the cost of capital. While a path toward meaningful long-term fiscal reform seems nearly incomprehensible at this point given the fractured political landscape, even minor spending decisions may weigh heavily on the near-term path of the economy and markets. A small amount of fiscal tightening in 2024 likely would raise the odds of a hard landing, for instance; but maintaining fiscal settings at current levels could open the door to renewed inflation or stagflation. Neither outcome is particularly good for risk-asset valuations.

Despite these hazards, the term premium on US Treasuries trended lower following the global financial crisis and spent much of the past five-plus years in negative territory. The lack of a persistently positive term premium suggests markets may not agree with our assessment of the risks—or, at the very least, they have grown complacent amid the many potential triggers for a re-rating of US Treasuries. And while we can't speculate about what may finally cause investors to demand meaningful premia for the uncertain long-term fiscal trajectory of issuers, we note that changes in sentiment can happen quickly and reverberate broadly across markets.

Macroeconomic risks have been further complicated by a new geopolitical theater of uncertainty. The liberal democratic ideals that the globalization trends of the late twentieth/early twenty-first centuries were expected to promote in many cases have been rejected in favor of autocracy. One result has been a loose coalition of

2. Source: Bloomberg, Haver Analytics, Federal Reserve Bank of Atlanta; data as of November 30, 2023.

authoritarian countries like China, Russia, North Korea and Iran, a "heartland axis" that control a vast, near-contiguous swath of land rich with natural resources across Eurasia and into the Middle East and northern Africa.

In recent years, this group has increased the volume and scope of its military adventurism, both directly and via proxies, and appears to have forged tighter relations as a result of a shared distaste for the liberal democracies scattered across the globe's periphery (North and South America, Western Europe, Oceana and parts of East Asia). At a minimum, these new alliances set the stage for greater friction in economic relations, and there are many ways in which current localized armed conflicts such as Ukraine/Russia and Israel/Hamas could escalate into something more far-reaching. Meanwhile, China's reputed intentions in Taiwan remain vexing to diplomats and investors alike.

Valuation of Growth Stocks and US Stocks Appear Stretched

Last year's performance did nothing to recalibrate the yawning valuation gaps for value stocks or non-US stocks, and both continue to trade at historically cheap valuations. The Russell 1000 Value Index, for example, is about as cheap relative to its growth counterpart as it has been in many decades.[3] This spread also may suggest that the old-economy businesses commonly associated with value indexes are pricing in a more sluggish economic reality than what is implied by valuations in the new-economy-biased growth universe. Ironically, it's possible this old-economy discount could serve as a potential shield against adverse developments while also promoting valuation elasticity to more positive economic outcomes.

Gold also remains undervalued relative to equities. The metal has ably played its role as a potential hedge against adverse events in recent years despite the headwind of rising real interest rates. After sinking to seven-month lows on the back of hawkish Fed sentiment, the price of gold surged in early October as Hamas' attack on Israel introduced a dangerous new variable to the already fraught geopolitical environment. With a constellation of other factors beyond its value as a perceived "safe haven" in uncertain times subsequently aligning in support of gold prices—increasing Fed dovishness, easing nominal and real interest rates, and a weakening US dollar, among them—the metal continued its climb over the balance of 2023 and ultimately established a new all-time nominal high around $2,078 per ounce in late December.[4]

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Prepared for Less Than Perfect

Though financial markets generally appear unconcerned with the challenges we see here early in the new year, we believe it's quite possible that risk aversion will at some point be higher than it is today. Though we wouldn't hazard a guess as to when that may be, owning a range of quality businesses with track records of consistent cash flow generation and wise capital allocation may be the least-bad option in such an environment. While even high-quality companies are unlikely to avoid losses in the event of worst-case scenarios, they should prove resilient and potentially be well-positioned to outperform once crisis recedes. Meanwhile, durable companies should also comport themselves well through less-extreme outcomes, like sluggish growth or stagflation.

3. Source: FactSet; data as of December 31, 2023.
4. Source: World Gold Council; data as of January 8, 2024.

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Risk Disclosures

All investments involve the risk of loss of principal.

A principal risk of investing in value stocks is that the price of the security may not approach its anticipated value or may decline in value. "Value" investments, as a category, or entire industries or sectors associated with such investments, may lose favor with investors as compared to those that are more "growth" oriented.

Investment in gold and gold-related investments present certain risks, including political and economic risks affecting the price of gold and other precious metals, like changes in US or foreign tax, currency or mining laws, increased environmental costs, international monetary and political policies, economic conditions within an individual country, trade imbalances, and trade or currency restrictions between countries. The price of gold, in turn, is likely to affect the market prices of securities of companies mining or processing gold and, accordingly, the value of investments in such securities may also be affected. Gold-related investments as a group have not performed as well as the stock market in general during periods when the US dollar is strong, inflation is low and general economic conditions are stable. In addition, returns on gold-related investments have traditionally been more volatile than investments in broader equity or debt markets. Investment in gold and gold-related investments may be speculative and may be subject to greater price volatility than investments in other assets and types of companies.

Diversification does not guarantee investment returns and does not eliminate the risk of loss.

Atlanta Fed Wage Growth Tracker is a three-month moving average of median wage growth based on hourly data.

Indexes are unmanaged and one cannot invest directly in an index.

MSCI World Index (Net) measures the performance of large and midcap securities across 23 developed markets countries around the world. The index provides total returns in US dollars with net dividends reinvested.

Russell 1000® Growth Index (Gross/Total) measures the performance of the large-cap growth segment of the US equity universe. It includes those Russell 1000 companies with higher price-to-value ratios and higher forecasted growth values. A total-return index tracks price changes and reinvestment of distribution income.

Russell 1000® Value Index (Gross/Total) measures the performance of large-cap value segment of the US equity universe. It includes those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values. A total-return index tracks price changes and reinvestment of distribution income.

S&P 500 Index (Gross/Total) is a widely recognized unmanaged index including a representative sample of 500 leading companies in leading sectors of the US economy. Although the S&P 500 Index focuses on the large-cap segment of the market, with approximately 80% coverage of US equities, it is also considered a proxy for the total market. The S&P 500 includes dividends reinvested. A total-return index tracks price changes and reinvestment of distribution income.

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