Financial markets finished 2023 on a high note, with a strong rally in November and December across all asset classes. The benchmark S&P 500 rose approximately 13% over the last two months of the year, and arguably more importantly, the U.S. Aggregate bond index rose over 7%, bucking its two-year decline. The aforementioned bond rally followed the 10 year U.S. Treasury yield briefly rising to 5% in October, the highest level since 2007. In our last quarterly letter, we wrote about the drivers of the rise in long term interest rates, and almost as soon as the ink had dried, the bond rally was on. After peaking at 5% on October 23, 10 year yields fell all the way back to 3.8% by year end.

The rally in both equities and bonds started in earnest following the Treasury Quarterly Refunding Announcement on November 1, where the Treasury Department announces its upcoming plans for U.S. government debt issuance. This normally mundane event has received more attention in recent quarters, due to the growing amount of bonds the Treasury has needed to issue into the market to fund the Federal government's fiscal deficits. In July, an unexpectedly high issuance announcement of long term bonds was the catalyst for the rise in long term rates. This quarter, with the bond market nervous about high issuance levels once again, the Treasury Department surprised to the downside, relieving both the equity and fixed income markets. The following day, at its November meeting, the Federal Reserve announced it was keeping short term rates unchanged, but emphasized that the decision should not be mistaken as a signal that they are done with their tightening cycle. The financial markets chose to ignore Chair Powell's "hawkish pause" messaging, continuing to rally through November and early December. Finally at the December meeting, the Fed, while leaving rates unchanged once again, came out with its most dovish commentary and outlook since 2021, including hinting at interest rate cuts to come in the new year. Following this "pivot", the bond market now expects six rate cuts in 2024, from 5.25% to 3.75%.

The sudden shift in tone from the central bank is the result of recent promising inflation data. Inflation has moderated more quickly than expected by the markets, and with less pain than many policy makers and investors believed necessary. Influential former Treasury Secretary Larry Summers has been suggesting publicly since 2022 that the U.S. would need five years of the unemployment rate above 5% to contain inflation. Celebrated investor Stanley Druckenmiller has repeatedly warned that once inflation has risen above 5%, it has never been tamed without a recession. Despite these warnings and the historical record, the Consumer Price Index (CPI) most recently rose at a 3.1% annual rate in November, while the unemployment rate remains near generational lows at 3.7%. The staggering rally in both stocks and bonds suggests that the market is pricing in a "soft landing", where inflation drifts back down to the Federal Reserve's target of 2% without a subsequent rise in unemployment and drop in GDP.

Can the rally continue in 2023? We believe so, although it may be a bumpy ride to start the year. Given the strength of the rally in November and December, it would not surprise us if the market required some turbulence and pullback to consolidate recent gains. Strong annual stock market performance is generally followed by continued gains, albeit more subdued than in the prior year. Going back to 1950, the last 20 instances of a 20%+ gain in the S&P 500 were followed up the next year with a positive return 16 times, but a higher return only once. Within the market indices, it is feasible that we will see a year in which the largest mega cap stocks take a “relative” breather after strong 2023 performance, with a broadening of the rally that sees smaller companies experience larger gains. While we are not bearish on the tech giants, the S&P 500 has become more concentrated at the top, and historically the equal weighted version of the index begins to outperform the market capitalization weighted version when this occurs. In this scenario, the broad indices end up higher but short of 2023 performance. These outcomes would be contingent on something close to the “soft landing” scenario playing out in the global economy. Much of the relative underperformance of smaller companies and other industry groups in comparison to the “Magnificent 7” has been due to the greater interest rate sensitivity within their balance sheets and business models. A decline in rates without a corresponding downturn in the business cycle could be a powerful driver to catapult a “broader” stock rally forward in 2024.

Of course, a soft landing may not be the ultimate destination for the economy in the coming year. The outlook for bonds may be even stronger than equities from a risk/return perspective for those worried that the economy may have more instability than currently priced in. Bonds tend to have strong performance following the last Fed rate hike, which may now be in the rearview mirror. Over the last six rate cut cycles, fixed income had positive forward 1 and 2 year returns in each case starting from the last hike. In a benign economic scenario, we would expect fixed income investments to benefit from a drop in rates across the curve, but to lag equities. However, in a scenario in which the economy underperforms, we would expect bonds to significantly outperform equities. As always, we will continue to monitor our individual holdings in this uncertain economic environment, assessing risks and opportunities across the entirety of asset classes in client portfolios.