# Fourth Quarter 2023 Commentary

An Oxford Harriman & Company Market Commentary

## Q4 2023 Market Commentary

Financial markets produced strong returns in the fourth quarter. Treasury yields, which spiked during the third quarter, reversed, and started to decline due to easing inflation and the Federal Reserve hinting at interest rate cuts in 2024. The decline in interest rates was the primary catalyst for both stocks and bonds, with bonds producing their best quarterly return since the second quarter of 1989.

## Treasury Yields Reverse Lower in Fourth Quarter

During the fourth quarter, longer-term yields reversed sharply and erased nearly all the increase from the previous quarter. This quick and sharp reversal in long-term yields is likely due to a significant change in expectations heading into 2024.

During the third quarter, Investors had two key concerns, both of which contributed to the sharp rise in Treasury yields. First, the U.S. economy continued to outperform expectations, which raised concerns that the Federal Reserve might need to keep interest rates high for an extended period to continue fighting inflation. Second, the fiscal deficit was growing quickly as government spending increased. Investors were concerned the U.S. Treasury would finance the growing deficit but that there wouldn't be enough buyers for the new bonds, potentially causing yields to rise if supply outweighed demand.

A notable shift occurred in November, leading to a sharp reversal in Treasury yields. Investor worries about increased Treasury bond issuance were alleviated as the U.S. Treasury revealed plans to slow the pace of bond issuance. The market felt there would be enough demand to absorb the new bonds, lowering the probability that too much bond supply would cause yields to rise. Additionally, economic data indicated that inflation continued to decline even as economic growth continued to exceed expectations. Investors' fears about persistent inflation and high interest rates started to fade, and yields declined.

## With Inflation Falling, Markets Expect Rate Cuts

As we begin 2024, economic data points to easing inflationary pressure. Headline inflation, which peaked at 9.1% in June of 2022, dropped to 3.1% in November of 2023. Likewise, core inflation, which excludes the volatile categories of food and energy, now stands at 4.0% after peaking at 6.6% in September of 2022. Price declines have been widespread across categories, with price pressures easing across food, energy, airfares, and household furnishings and appliances.

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Investor optimism has been increasing as price pressures have subsided, with inflation forecasted to remain stable and possibly fall further during 2024. Additionally, the Federal Reserve is discussing the possibility of interest rate cuts in 2024, a topic that will be closely watched by economists and investors this year. However, we believe investors may be too confident that the Fed will cut interest rates in early 2024, and this debate will likely contribute to both stock and bond volatility. The interest rate futures market currently forecasts six rate cuts, with the first cut as early as March. This contrasts with the third quarter of last year, when there was concern that the Federal Reserve would need to keep raising interest rates. Again, one of the key themes to watch in 2024 will be if, when, and by how much the Federal Reserve cuts rates. More importantly, the reasoning behind any rate cuts will be important and could lead to unexpected bouts of volatility and equity market stress.

## U.S. Economy Remained Resilient in 2023

A big unknown heading into 2023 was whether the economy could withstand the effects of higher interest rates. The Federal Reserve aimed to fight stubborn inflation by raising interest rates, and the central bank appeared to be well on its way toward accomplishing its goal, with the cost of capital rapidly increasing. Both home sales and home construction activity were slowing. Shipping rates were falling as freight demand declined and supply chains normalized.

***While portions of the economy slowed in 2023, the broader economy displayed remarkable resilience, even as the Federal Reserve continued to raise interest rates. In fact, the U.S. economy grew at a 4.9% annualized pace in the third quarter, representing the fastest pace since the fourth quarter of 2021.***

While portions of the economy slowed in 2023, the broader economy displayed remarkable resilience, even as the Federal Reserve continued to raise interest rates. In fact, the U.S. economy grew at a 4.9% annualized pace in the third quarter, representing the fastest pace since the fourth quarter of 2021. Multiple factors contributed to this above-average growth, including consumer spending, government investment at the federal and state levels, and companies restocking inventories after COVID.

U.S. home prices increased dramatically during the pandemic, as factors like remote work, low mortgage rates, and rising wages boosted home demand. Home prices initially peaked in mid-2022 and declined over the next 10 months as rising mortgage rates weighed on demand. However, home prices rose to record highs as the housing market reaccelerated in the second half of 2023.

Finally, the U.S. unemployment rate remains below 4%, a level that is low by historical standards and showcases the labor market's strength.

While these data points are lagging and reflect past performance, they underscore the economy's resilience. They also may indicate that higher interest rates aren't having the impact that many thought they would. With inflation falling and the economy growing, some are starting to believe that the Fed can achieve its goal of lowering inflation without negatively impacting the economy. We remain skeptical; however, that the Fed can achieve the ideal "soft landing" and combat inflation without impacting overall economic growth.

## Equity Market Recap – Stocks Trade Near Highs

***The broad-based stock market rally demonstrates investors' growing enthusiasm, with inflation falling, the economy surpassing expectations, and the Fed signaling the end of rate hikes.***

Falling interest rates helped stocks have a strong fourth quarter. Key stock market indices such as the S&P 500, the Dow Jones, the NASDAQ 100, and the Russell 2000 each returned more than 11%. Real estate was the top-performing sector as falling interest rates relieved pressure on property owners, and cyclical sectors outperformed defensive sectors. In December, the Russell 2000 Index of small cap stocks outperformed the S&P 500 by 7.6%, its biggest month of outperformance since February 2000. The broad-based stock market rally demonstrates investors' growing enthusiasm, with inflation falling, the economy surpassing expectations, and the Fed signaling the end of rate hikes.

At year-end, the S&P 500 is hovering near its January 2022 all-time high. Through 2023, stocks defied higher interest rates, geopolitical tensions, and multiple U.S. regional bank failures to record solid and unexpected gains.

During the fourth quarter, international stocks underperformed U.S. stocks for the third consecutive quarter. This underperformance can be attributed to multiple factors. First, international stock market indices lack exposure to large companies benefiting from artificial intelligence. Second, as discussed above, the U.S. economy has displayed resilience to higher interest rates. In contrast, some countries and regions outside the U.S. are already showing the impact of higher interest rates.

## Credit Market Recap – Bonds Prices Increase as Interest Rates Decline

Bonds also traded higher during the fourth quarter as Treasury yields reversed their third quarter rise. The Bloomberg U.S. Bond Aggregate, which tracks a broad index of U.S. investment-grade rated bonds, produced a total return of 6.7% during the fourth quarter. This was the first quarterly gain since the first quarter of 2023, and the biggest quarterly gain since the second quarter of 1989. As mentioned above, the fourth quarter rally in bonds was attributed to declining inflation and the expectation that the Federal Reserve is expected to start cutting interest rates.

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After an extended period of negative returns as the Federal Reserve raised interest rates, bonds are now experiencing a resurgence in popularity. Investors have been trying to time the top in Treasury yields, and as sentiment improved and rates declined in the fourth quarter, investors rushed to lock in yields. It's a dynamic that's played out in recent quarters, which has contributed to the increased bond market volatility. As we begin 2024 investors are hopeful that rates have peaked.

## 2024 – What to Watch?

For the full year 2024, analysts expect S&P 500 earnings to grow 12% according to FactSet (Insight.factset.com.)  In 2023 prices were driven largely by sentiment related to interest

rate expectations and excitement related to artificial intelligence. With the S&P 500 currently trading at 19.2 times projected earnings, compared with a five-year average of 18.9 according to FactSet, we believe earnings will be the catalyst for price appreciation in 2024.

Heading into the new year, the economy is growing at a solid pace, the labor market remains strong, inflation is decelerating, and the housing market shows early signs of a rebound. Economic data indicates that higher interest rates have yet to make a significant impact, and the recession many were predicting in 2023 did not occur. Stocks trade near all-time highs, and bonds just staged their best quarter since 1989. There is a growing sense of optimism, but can the economy live up to that optimism?

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Multiple themes suggest the U.S. economy experienced a structural shift during the pandemic. Cross country migration is driving increased government investment today as states and local municipalities expand and build infrastructure to meet increased demand and utilization. This translates into new schools, more expansive road networks, new neighborhoods, and airport expansions. Additionally, there is still a housing shortage after the U.S. underbuilt following the 2008 financial crisis. Remote work is a new phenomenon, but it doesn't appear to be going away anytime soon. Fridays and Mondays are no longer constraints on taking a weekend trip, which could lead to more spending on services and experiences. It takes time for higher interest rates to work their way into the economy, and the economy could slow in 2024. However, these structural changes demonstrate how today's economy differs from the pre-pandemic economy.

During 2024 the presidential election will grab headlines for most of the year, with the first primary elections taking place this month. The media will be full of advertisements and debates as candidates discuss their platforms. There will be a lot of talk about new policies and proposed changes, but it's important to keep the bigger picture in mind. Election headlines tend to be more noise than anything of substance. Elections create uncertainty and volatility, but history shows us that economic growth and corporate earnings ultimately drive markets over the long term. Our focus in 2024 will be on the growing list of non-political themes, such as interest rate cuts, geopolitics, and earnings & economic growth.

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We thank you for your continued support and are available at any time to discuss any questions you may have about the overall investing environment or your individual portfolio,

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The S&P 500 Index consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market value weighted index with each stock's weight in the Index proportionate to its market value. The Russell 2000® Index measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represents approximately 8% of the total market capitalization of the Russell 3000 Index. The NASDAQ 100 Index is an unmanaged group of the 100 biggest companies listed on the NASDAQ Composite Index. The list is updated quarterly and companies on this Index are typically representative of technology-related industries, such as computer hardware and software products, telecommunications, biotechnology and retail/wholesale trade. The MSCI EAFE Index is designed to represent the performance of large and mid-cap securities across 21 developed markets, including countries in Europe, Australasia and the Far East, excluding the U.S. and Canada. The MSCI Emerging Markets Index is designed to represent the performance of large- and mid-cap securities in 24 Emerging Markets. Bloomberg U.S. Aggregate Bond Index is a broad-based measure of the investment grade, US dollar-denominated, fixed-rate taxable bond market.

Additional information is available upon request. PM -07092025-6206139.1.1