Q4 2023: Recession Avoided in 2023—Now What?

By Peak Trust Company's Chief Investment Officer, Lisa Russell, CFA. February | 2024

HIGHLIGHTS

- Despite recession fears and a banking crisis in early 2023, the market rallied with U.S. large cap stocks up 26.3% and U.S. intermediate-term bonds up 5.5%, buoyed by moderating inflation.
- Last year's positives included resilient U.S. consumers, a tight labor market, and a nascent artificial intelligence boom, although some negatives persisted, such as heightened geopolitical tensions and an extended manufacturing slump.
- U.S. retail sales were strong as credit card usage rose rapidly, and U.S. government deficit spending reached record levels, which raised concerns about the country's fiscal health.
- The Fed is delicately managing inflation versus recession risks, while the Treasury must navigate rolling massive amounts of government debt amid reduced foreign demand. Investors are facing wide-ranging scenarios from significant downside risks to an economic re-acceleration.

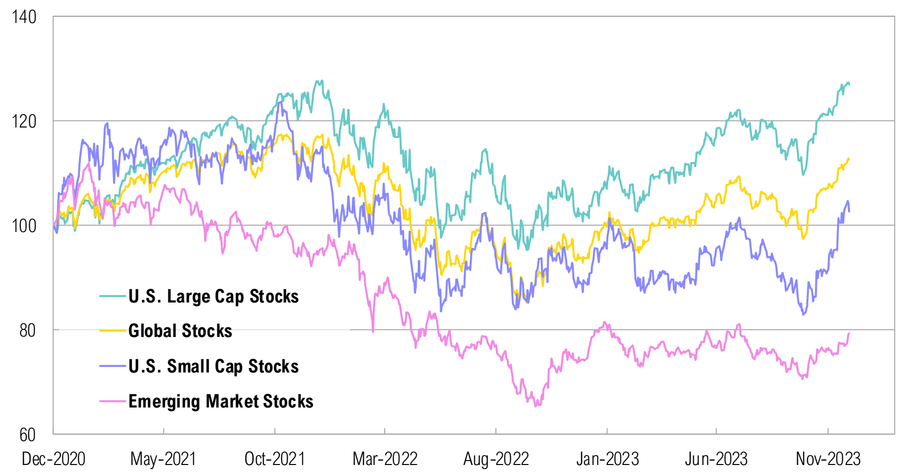
Review of 2023

Markets were strong in the fourth quarter. For example, U.S. large cap stocks ended the quarter up 11.7% and the year up 26.3%. Even with these impressive gains, the S&P 500 Index ended the year one percentage point shy of its all-time high in January 2022, almost two years ago.

Breaking the trend of the two previous years, 2023 was also positive for U.S. intermediate-term bonds. The Bloomberg Aggregate Bond Index rose 6.8% in the fourth quarter to end the year up 5.5%. The index gained 8.5% in the last two months of 2023, marking the best two-month performance for U.S. bonds since September to October 1982, when the index increased 9.6%.

Global Equities Rebounded in 2023 as Recession Fears Eased

Growth of 100



Source: Bloomberg

What drove this impressive snap-back in asset prices? The answer likely lies as much in what happened as what did not happen. What happened last year was declining inflation, robust nominal GDP growth, a resilient labor market and consumer, but also a banking crisis, proliferating armed conflicts, and flat lining corporate earnings. What did not happen was the widely feared recession that had many investors positioned cautiously coming into 2023.

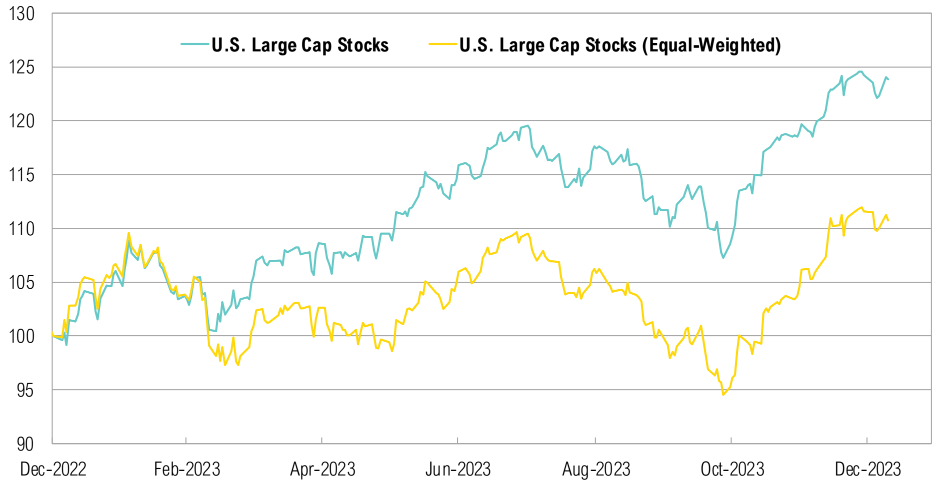
Headline inflation, which started 2023 at 6.4% year-over-year, gradually eased to 3.1% by November. The U.S. banking system also experienced its greatest crisis since the Global Financial Crisis (GFC) in March, triggered by a significant loss of deposits in several domestic U.S. banks. The Federal Reserve intervened and launched new programs, including the Bank Term Funding Program (BTFP) that provides long-term, low-cost loans to banks in order to shore up liquidity and stability.

The Magnificent Seven

The AI boom, ignited by the launch of ChatGPT in November 2022, was another significant factor influencing the markets. This enthusiasm was reflected in the technology sector's impressive performance in 2023. The "Magnificent Seven"—Meta, Apple, Amazon, Nvidia, Alphabet, Microsoft, and Tesla, all mega-cap and tech-related companies in the S&P 500—saw an impressive rebound. After declining by an average of 45.3% in 2022, they ended 2023 with an average total return gain of 104.7%.

The S&P 500 Beat Equal-Weighted S&P 500 by Near-Record Spread

Growth of 100



Source: Bloomberg

In fact, these seven stocks alone accounted for 62.2% of the S&P 500's full-year return for 2023. Without this group, the index's return was only 9.9%. The collective market value of these Magnificent Seven companies is now quadruple that of the entire Russell 2000, a widely followed small cap index of 2,000 publicly traded companies. The unusual concentration of gains in just a few stocks is starkly illustrated by the 12% spread between the equal-weighted S&P 500 and the market cap-weighted index, with the former trailing the latter by the second-largest calendar year spread since at least 1971.

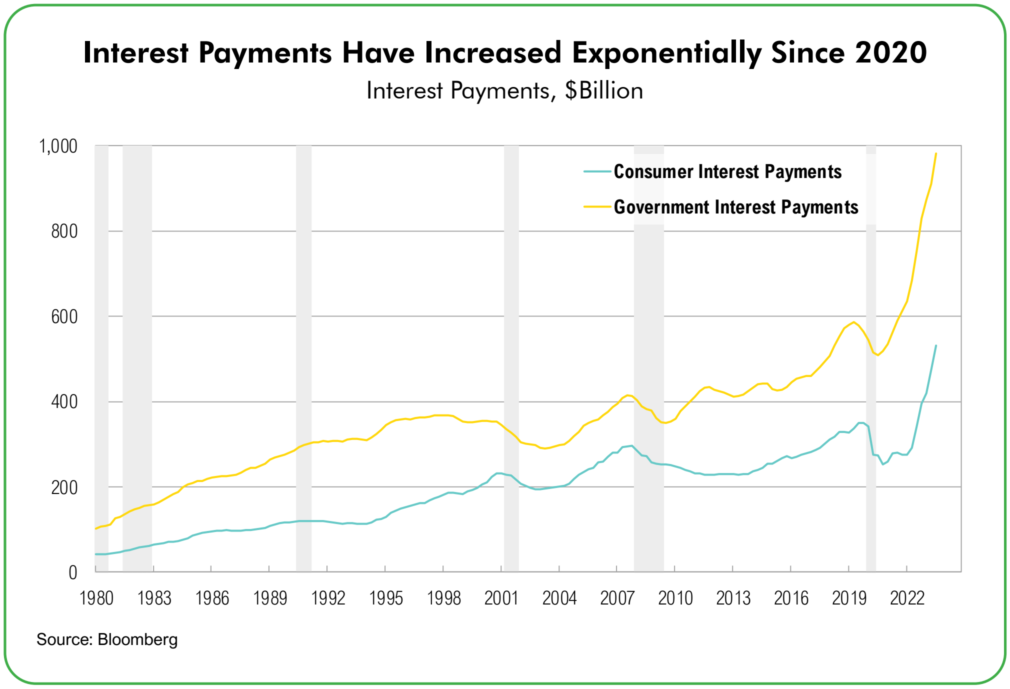
Wars Around the World

Geopolitical tensions persisted in 2023. The conflict in Ukraine continued, and in October, a new conflict erupted in Israel following an attack by Hamas. In December, major global shippers, such as Maersk and Hapag-Lloyd, were forced to reroute cargo around the tip of Africa instead of passing through the Suez Canal due to intensified attacks by the militant group Houthi in the Red Sea. If left unresolved, these disruptions could drive up global shipping costs and reignite inflation for the cost of goods.

On the Domestic Front

Domestically, two key factors defined 2023 and remain critical heading into 2024: the resilience of the U.S. consumer and the alarming rate of U.S. government deficit spending. Retail sales initially slumped at the start of the fourth quarter, raising concerns among major retailers about weak holiday spending. However, this trend reversed as the quarter progressed.

In fact, U.S. consumers remained remarkably resilient throughout 2023, supported by excess pandemic savings and strong job markets. However, consumers' revolving credit rose to an all-time high of $1.3 trillion in November, and the average



interest rate on a new credit card rose to a record 24%, compared to an average rate of 14.5%, and this recent acceleration in credit card debt is concerning, especially given the context of full employment.

Corporate earnings growth was sluggish in 2023 and is expected to come in at just 0.6% on a year-over-year basis for the S&P 500. Looking forward in 2024, analysts project year-over-year earnings growth of 11.5% and revenue growth of 5.5% for the S&P 500. Even with this optimistic outlook, stocks do not appear cheap. The forward 12-month price-to-earnings (P/E) ratio of 19.3 is above the 5-year average of 18.8 and well above the 10-year average of 17.6.

Yet, as inflation eased and the feared recession remained at bay, equity prices rose, and investors took on more risk, with some measures of investor risk appetite increasing at an unprecedented pace during the fourth quarter. According to the December 27, 2023 weekly American Association of Individual Investors (AAII) Investor Sentiment Survey, 46% of respondents were bullish on the stock market for the next six months. According to the CNN Fear & Greed Index, extreme greed had been driving the market in December.

Balancing Act

Amid a backdrop of declining inflation and an economy losing steam, the Fed finds itself on a tightrope, trying to wring out the remnants of unwanted inflation without causing a recession.

By this year's end, with inflation appearing subdued, the path forward seems clearer, yet the real test for the Fed will be the cadence and timing of interest rate reductions. Premature cuts risk reigniting inflationary pressures, while delayed actions could exacerbate the downturn effect of prior hikes, potentially steering the U.S. economy into recession during an election year.

After peaking at a four-decade high of 9.1% in June 2022, headline inflation eased to 3.1% year-over-year in November. While core inflation remains stickier, at 4.0% year-over-year, it is still a marked improvement from the high of 6.6% in September 2022. Given the notable progress made with bringing inflation back down to its target of 2.0%, the Federal Reserve has not hiked interest rates since July 2023, keeping its policy rate at an effective 5.33% (range of 5.25% to 5.50%). On December 13, at the last Federal Open Market Committee (FOMC) meeting of 2023, Fed Chairman Jerome Powell hinted that the Fed may be at the end of its rate hiking cycle and preparing for rate cuts in 2024.

Although inflation appears under control, premature rate cuts carry risks. Recent data show that the U.S. housing market is ramping up again, potentially leading to higher month-over-month inflation prints. Fortunately, the risk of stagflation—characterized by slowing growth, high unemployment, and rising inflation—appears negligible, but concerns could rise down the road if inflation re-accelerates.

What Will the Fed Do?

What about the risks of a recession if the Fed does not cut? Although some economic data still call for caution, most market participants have shifted to a much more optimistic tone. Only 21% of the Bank of America's Fund Manager Survey respondents anticipate a hard landing or recession in the next year, compared to nearly 70% expecting a recession in November 2022. This is despite the Conference Board's Leading Economic Index signaling a recession for the 19th consecutive month, a firmly inverted yield curve (ending 2023 at -35 basis points), the 14th-consecutive month of contraction in the manufacturing sector according to the ISM Manufacturing PMI, and December's ISM Services reading badly missing expectations and narrowly averting a reading below 50, which is consistent with outright contraction.

Commercial Real Estate

Higher interest rates have created significant challenges for commercial real estate (CRE), particularly in the office sector. The shift to remote work after the pandemic contributed to total U.S. office vacancies climbing to 20%, surpassing the peak GFC vacancy rate of 17.6%. The growth of e-commerce has also adversely affected physical stores.

The multifamily sector continued to face increasing operating costs and refinancing challenges amid rising interest rates. Despite falling prices, constant CRE debt levels are driving up leverage and exacerbating solvency issues. Smaller domestic U.S. banks, which hold 70% of all CRE loans, face a significant risk. Recent studies by the St. Louis Federal Reserve and the National Bureau of Economic Research (NBER) reveal that smaller banks are especially prone to insolvency risks from uninsured depositor runs.

In key lending areas for several specific U.S. commercial banks, there has been a noticeable credit deterioration, a situation that could worsen with ongoing higher rates. If current interest rate levels continue, debt defaults could increase, and other significant repercussions could emerge in the banking sector.

The Fed's tricky task of navigating interest rate levels has rightfully received ample attention, but what has been much less discussed, albeit no less important, is the balancing act facing the U.S. Treasury and Secretary Yellen. Nearly $9 trillion in government debt must be rolled over at higher interest rates amid waning foreign investment in U.S. Treasury markets. This challenge is amplified by the impending pressures of an election year, where fiscal decisions may be scrutinized for their long-term impact on the economy.

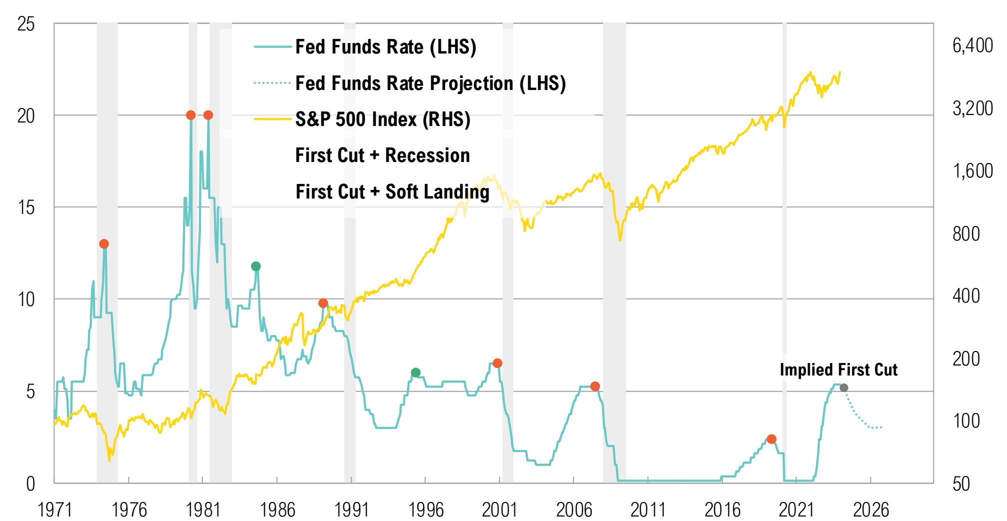
Debt Debate

Government spending has been a key theme throughout 2023, starting with the debt ceiling debate in May. The U.S. government reached a $1.7 trillion deficit at the end of the 2023 fiscal year—the largest in a non-recessionary or non-crisis year in history. Despite this, the government has continued to spend at a rapid pace. This could challenge government spending productivity and overall fiscal health heading into an important election year.

Investors are left with questions that only time can answer:

Seven of the Past Nine Hiking Cycles Were Followed by Recession

Fed Funds Rate %



Source: Bloomberg

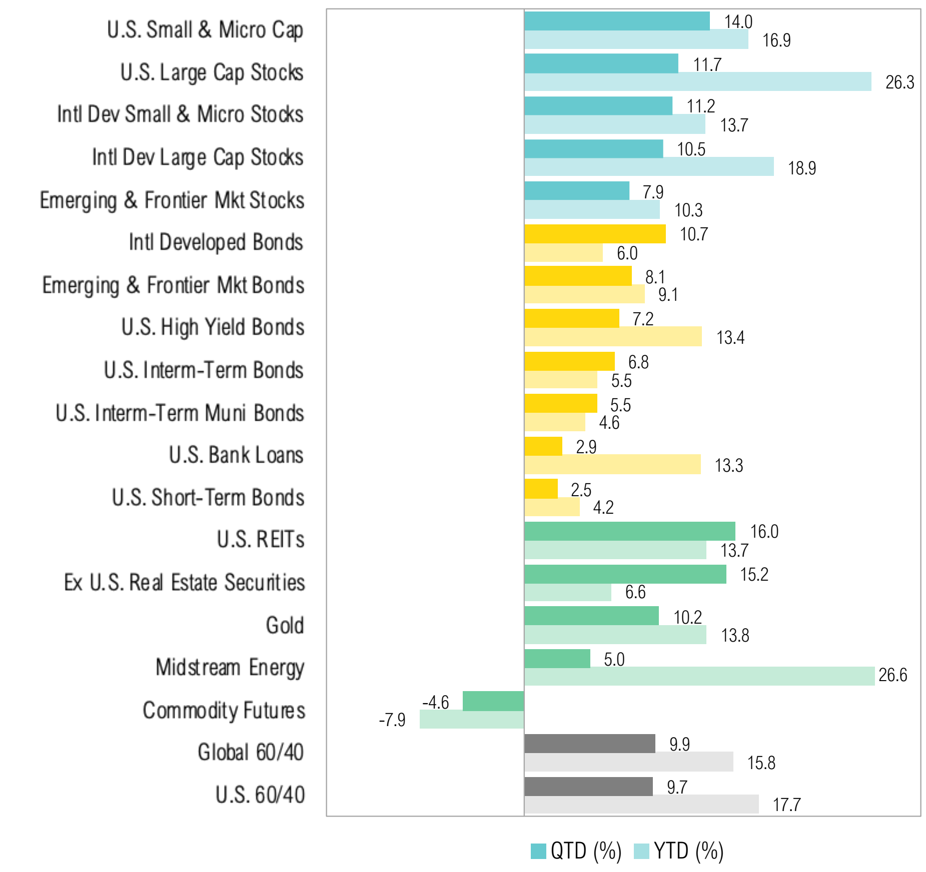
Can the Fed's anticipated rate cuts ease economic strains and support markets for another year or longer? Will the Treasury be able to capably handle government debt? Historically, soft landings have been quite rare, as seven out of the past nine hiking cycles were followed by a recession.

Markets

Only one asset class—commodity futures—finished the year (and the quarter) in negative territory, ending 2023 down 7.9%. On the other end of the spectrum, U.S. large cap stocks ended the year up 26.3% with international large cap stocks gaining 18.9% in 2023. U.S. small and micro cap stocks gained an impressive 14.0% over the fourth quarter, pushing 2023 returns up to 16.9%. It was a rollercoaster year for the 10-year Treasury yield, which peaked at 4.98% on October 18 before ending the year where it started, at 3.9%. Fueled by November's stellar performance, U.S. intermediate-term bonds ended 2023 up 5.5% largely due to heightened geopolitical tensions and their role as a safe-haven asset. Gold gained a respectable 10.2% throughout the fourth quarter to end the year up 13.8%.

China's planned post-pandemic economic recovery stalled in 2023. For the first time since 2013, Chinese President Xi Jinping acknowledged in a New Year's Eve speech that his country's economy is struggling, as unemployment remains elevated at 5% and domestic consumer demand weakens.

Q4 2023 Key Market Total Returns



Source: Bloomberg

Looking Forward

In 2024, policymakers and investors alike find themselves navigating a delicate balancing act across potential economic extremes. On the one hand, there's the possibility of an economic re-acceleration that could be good for stocks by potentially broadening the narrow market gains of last year. On the other, we might face a "hard landing" characterized by falling inflation and yields, which could favor bonds.

Further complicating the outlook is the challenge in anticipating policy moves ahead of a presidential election. For instance, policymakers, grappling with a mountain of debt, rising interest costs, and limited options, seem cornered into reducing interest rates, irrespective of whether it's the right thing to do. While this strategy might alleviate immediate fiscal challenges, it risks doing even more long-term harm to the U.S. economy.

For now, markets seem comfortable with short-termism at the expense of worsening longer-term issues, which is another balancing act that merits watching as 2024 unfolds.

Wherever we land, different scenarios call for varying approaches to asset allocation, emphasizing the ever-relevant role of diversification in portfolio management.

Below is a “diversification quilt” that does a really good job of explaining why it is so important to be invested in multiple asset classes and not just the Magnificent 7.

“Diversification Quilt”

Why Diversification Matters

	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	YTD	10 Years
Best performing asset class	US Small Cap 4.9%	US REITs 2.5%	US REITs 8.6%	US Small Cap 14.6%	EM Stocks -14.6%	Cash 2.2%	US Large Cap 21.0%	Gold -3.8%	US REITs -24.5%	Midstrm Energy 26.6%	Midstrm Energy 26.6%	US Large Cap 11.8%
	US Large Cap 13.2%	US Large Cap 0.9%	Muni Bonds -0.1%	Midstrm Energy -6.5%	Ex-US REITs -9.4%	Muni Bonds 5.6%	US REITs -7.6%	US Large Cap 26.5%	Midstrm Energy 30.9%	Commodities -7.9%	US Large Cap 26.5%	US REITs 7.6%
	Midstrm Energy 4.8%	US Int-T Bnds 0.5%	EM Bonds 9.9%	US High Yield 7.5%	Intl Dev Stcks -13.8%	US Int-T Bnds 8.7%	US Small Cap 20.0%	US Small Cap 14.8%	Commodities 16.1%	Cash 5.1%	Intl Dev Stcks 18.2%	US Small Cap 7.2%
	Intl Dev Stcks -4.9%	US Small Cap -4.4%	US Large Cap 12.1%	US Large Cap 21.7%	US Large Cap -4.8%	Gold 18.8%	Intl Dev Stcks 7.8%	EM Stocks -2.5%	US Large Cap -19.1%	Gold 13.8%	US Small Cap 16.9%	Gold 5.6%
	Global 60/40 3.0%	Midstrm Energy -32.6%	US Int-T Bnds 2.6%	Commodities 1.7%	Global 60/40 -5.7%	US High Yield 14.3%	Ex-US REITs -6.8%	Global 60/40 9.9%	US Small Cap -20.4%	Muni Bonds 4.6%	Global 60/40 16.1%	Global 60/40 5.5%
	US High Yield 2.5%	EM Bonds 1.3%	Cash 0.3%	EM Stocks 37.3%	US Small Cap -11.0%	Intl Dev Bnds 4.6%	Global 60/40 13.6%	Intl Dev Bnds -9.5%	Intl Dev Stcks -14.5%	US High Yield 13.4%	Gold 13.8%	US High Yield 4.6%
	Ex-US REITs 3.4%	Muni Bonds 2.4%	Intl Dev Stcks 1.0%	EM Bonds 8.2%	Gold -1.1%	EM Bonds 13.1%	Gold 24.2%	Intl Dev Stcks 11.3%	Global 60/40 -16.0%	US Int-T Bnds 5.5%	US REITs 13.7%	Intl Dev Stcks 4.3%
	US REITs 30.4%	Ex-US REITs -1.8%	Ex-US REITs 2.0%	Gold 11.9%	Intl Dev Bnds -2.3%	US REITs 25.8%	EM Stocks 18.3%	US Int-T Bnds -1.5%	Ex-US REITs -22.2%	Intl Dev Stcks 18.2%	US High Yield 13.4%	EM Bonds 3.0%
	Cash 0.0%	Global 60/40 -2.5%	Global 60/40 5.9%	US REITs 5.1%	EM Bonds -2.5%	US Large Cap 31.4%	US High Yield 7.1%	US High Yield 5.3%	US High Yield -11.2%	EM Bonds 9.1%	EM Stocks 9.8%	EM Stocks 2.7%
	Muni Bonds 4.7%	US High Yield -4.5%	US Small Cap 21.3%	Global 60/40 17.4%	US High Yield -2.1%	Global 60/40 19.2%	EM Bonds 6.5%	EM Bonds -1.7%	Muni Bonds -4.8%	Global 60/40 16.1%	EM Bonds 9.1%	Muni Bonds 2.2%
	Intl Dev Bnds -2.1%	Cash 0.0%	US High Yield 17.1%	US Int-T Bnds 3.5%	US REITs -4.6%	Ex-US REITs 21.9%	US Int-T Bnds 7.5%	Muni Bonds 0.5%	Cash 1.5%	US Large Cap 26.5%	Ex-US REITs 6.7%	Midstrm Energy 1.9%
	US Int-T Bnds 6.0%	Gold -11.4%	Intl Dev Bnds 1.6%	Ex-US REITs 26.6%	US Int-T Bnds 0.0%	US Small Cap 25.5%	Commodities -3.1%	Cash 0.0%	US Int-T Bnds -13.0%	EM Stocks 9.8%	Intl Dev Bnds 6.0%	US Int-T Bnds 1.8%
	EM Stocks -2.2%	Intl Dev Bnds -6.6%	Gold 9.1%	Intl Dev Bnds 11.3%	Muni Bonds 1.6%	Commodities 7.7%	Midstrm Energy -28.7%	Commodities 27.1%	EM Bonds -15.3%	US Small Cap 16.9%	US Int-T Bnds 5.5%	Ex-US REITs 1.7%
	EM Bonds 4.8%	EM Stocks -14.9%	EM Stocks 11.2%	Intl Dev Stcks 25.0%	Commodities -11.2%	Midstrm Energy 6.6%	Muni Bonds 4.2%	Ex-US REITs 5.7%	EM Stocks -20.1%	Intl Dev Bnds 6.0%	Cash 5.1%	Cash 1.2%
	Commodities -17.0%	Intl Dev Stcks -0.8%	Commodities 11.8%	Cash 0.8%	Cash 1.8%	Intl Dev Stcks 22.0%	Intl Dev Bnds 11.2%	US REITs 43.1%	Gold -0.4%	Ex-US REITs 6.7%	Muni Bonds 4.6%	Commodities -1.1%
Worst performing asset class	Gold -0.2%	Commodities -24.7%	Midstrm Energy 18.3%	Muni Bonds 3.5%	Midstrm Energy -12.4%	EM Stocks 18.4%	Cash 0.5%	Midstrm Energy 40.2%	Intl Dev Bnds -21.8%	US REITs 13.7%	Commodities -7.9%	Intl Dev Bnds -1.3%

About Lisa

Lisa Russell started with Peak Trust Company in 2003 and currently serves as Chief Investment Officer. Lisa brings over 25 years of investment experience to the Peak team. She specializes in designing unique investment programs for high-net-worth clients and trust accounts. She is highly attuned to the tax consequences of investment actions.

Lisa holds a Master of Business Administration in Finance from Emory University and a Bachelor of Science in Business Administration from the University of Southern California. Lisa holds the designation of Chartered Financial Analyst (CFA), and is a member of the CFA Institute and the CFA Society of Seattle.

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Chief Investment Officer

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