Market Strategy
by STRATEGAS A BAIRD COMPANY

BAIRD
Private Wealth Management

Quarterly Market Update

Fourth Quarter, 2023

A FOURTH QUARTER FOR THE RECORD BOOKS

Hard to imagine. It might be difficult to believe but on Friday, October 27, the S&P 500 was slouching toward 4,100 (down over 10% from late July), previously high-flying and speculative assets were lagging substantially, and the 10-year Treasury was yielding 4.83%. In the next 10 weeks, the S&P rallied 17%, year-to-date laggards were once again ascendant, and the yield on the 10-year Treasury note fell by more than 90 basis points (0.9 percentage points).

Janet Claus. On the morning of Wednesday, November 1, Strategas Head of Policy Research Dan Clifton sent a quick note that read simply "Janet Yellen may have just saved Christmas." What happened? Put simply, the Treasury Department doubled down on issuing short-term debt in its Quarterly Refunding Statement, marking the peak in 10-year yields for the year by creating scarcity at the long-end of the yield curve (more demand chasing fewer bonds pushing yields down). From a tactical and political point of view, it was a masterstroke for the Biden administration. The wisdom of the federal government funding large long-term liabilities with short-term funding will be left for future generations to assess.

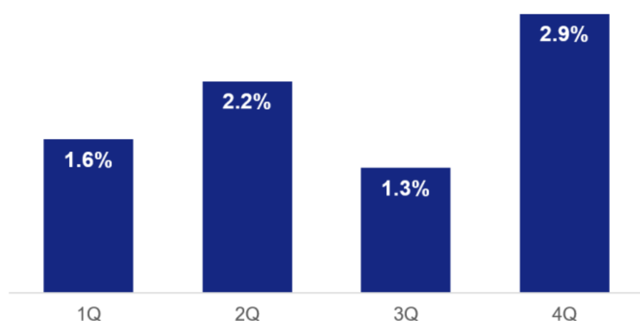
Fed pivot. The markets got a further shot in the arm when it seemed as if Fed Chairman Powell declared victory over inflation in mid-December, leaving behind his admonitions against repeating the "stop-and-go" monetary policies of the 1970s. The rate of inflation has fallen markedly since peaking in summer 2022. But the wisdom of the Federal Reserve appearing to declare "Mission Accomplished" on inflation with the unemployment rate at 3.7% will also be left to future generations to determine.

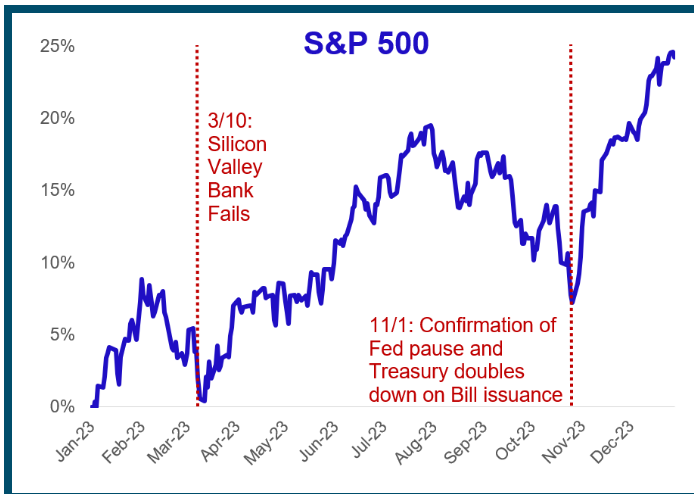
A big year. For both the Fed and the Biden administration, ahead of what will be an election year for the ages, the future is now. The S&P 500's nearly 27% total return in 2023 is all the more remarkable when one considers the fact that the Index's operating earnings are likely to be flat year over year, and 10-year yields (also about flat on the year) were up roughly 120 basis points over the first 10 months of 2023.

Artificial Intelligence. Of course, no review of 2023 would be complete without some discussion of the potentially revolutionary impact on business and on society of generative Artificial Intelligence. For a good portion of the year, this potential was largely confined, in market terms, to the performance of the "Magnificent 7" (more on that on the following page). As late as October 31, the performance of these seven stocks accounted for more than 130% of the market's overall returns. Since then, the market has broadened out considerably, with the equal weight S&P 500 up 16.6% from Oct. 31 through Dec. 31, offering hope that the current bull market has legs.

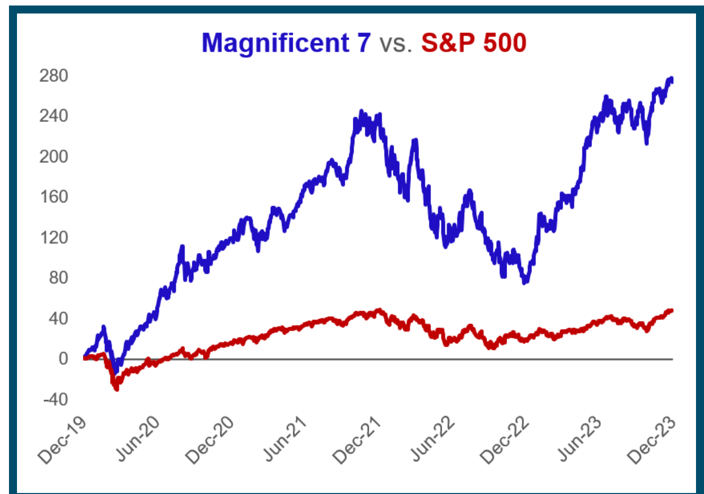
Asset Class	Representative Benchmark	Q4 Return
US Large Cap	S&P 500	11.7%
US Small Cap	Russell 2000	14.0%
International	MSCI AC World ex-USA (USD)	9.8%
Commodities	Bloomberg Commodity	-4.6%
Municipal Bonds	Bloomberg Municipal Bond	7.9%
Taxable Bonds	Bloomberg US Aggregate	6.8%
Cash	Bloomberg 3-Month T-Bill	1.4%

S&P 500 Average Quarterly Return (since 1928)

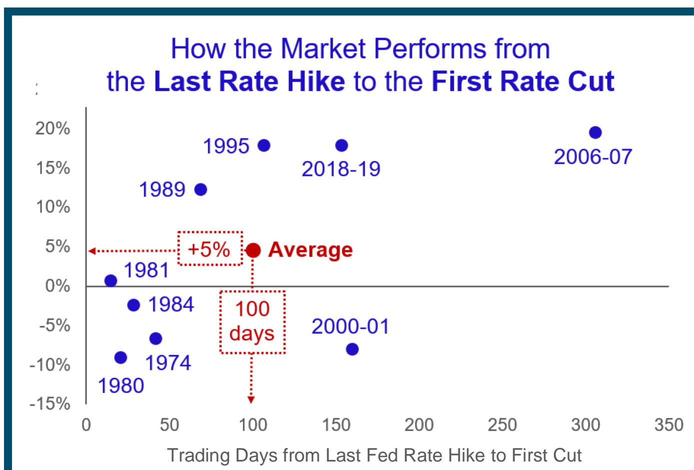




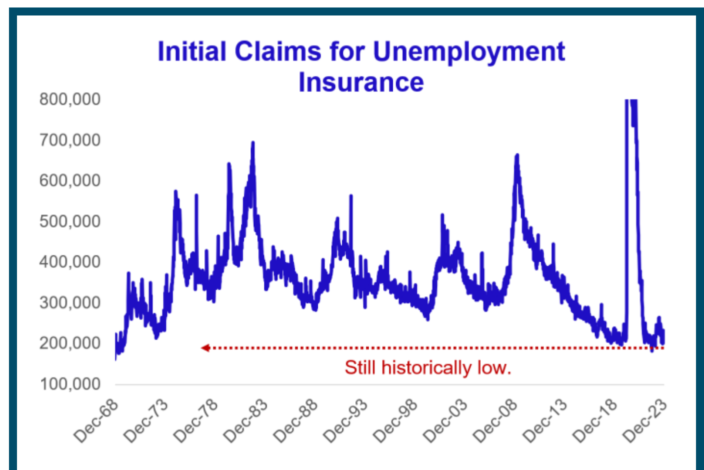
The S&P was up just +0.6% YTD before Silicon Valley Bank failed in March. To prevent a contagion event, policymakers sprung into action with several stimulative programs (the Fed's BTFP expanded its balance sheet by $300 billion in 3 weeks, the TGA injected ~$550 billion into the economy through May, etc.). This stealth liquidity boost provided a catalyst for markets to rally into the summer months. Similarly, the Treasury's November decision not to increase long-term debt issuance but to finance the deficit with more T-bills led to a significant liquidity injection and helped catalyze long-term bond yields lower, ultimately helping spark another big rally in stocks.



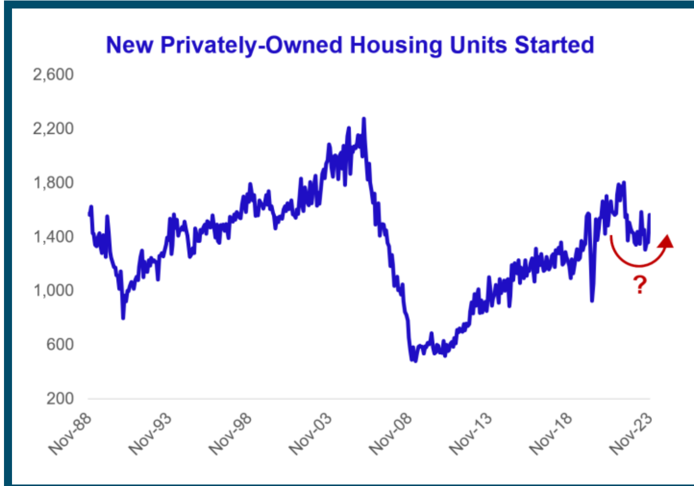
The Magnificent 7 (Amazon, Tesla, Meta, Nvidia, Apple, Microsoft, Alphabet) accounted for more than 130% of the S&P 500's total return as recently as October. Even after that number fell to "just" 70% by year-end, 2023's market rally could only be characterized as very narrow. However, since interest rates peaked on October 23, the market actually began to broaden out considerably. The equal-weight S&P outperformed the Magnificent 7 by nearly 500 basis points into year-end, and even the recent reversal in yields didn't change that trend. This shift in leadership is worth watching closely into the new year.



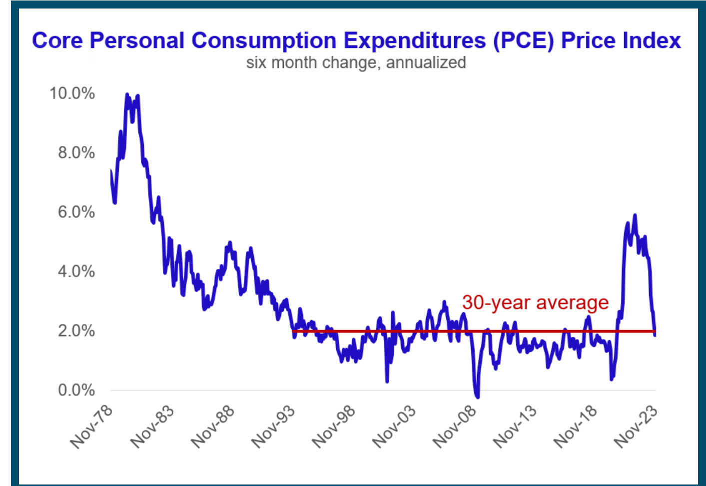
Analyzing Fed rate cycles since the 1970s shows that, generally, investors have more to fear from the first rate cut in a cycle than the period in which the Fed has stopped tightening but has yet to ease (i.e., where we are now). On average, the S&P 500 is up about +5% over 100 days between the last Fed hike and the first cut. But the trough in the broader market is more than -23% over 200 days after the first rate cut in a series. So, while markets have rallied in part on pulled-forward expectations for Fed easing, investors may want to be careful what they wish for. The Fed pivot may be on, but multiple near-term rate cuts might be more ominous than many realize.



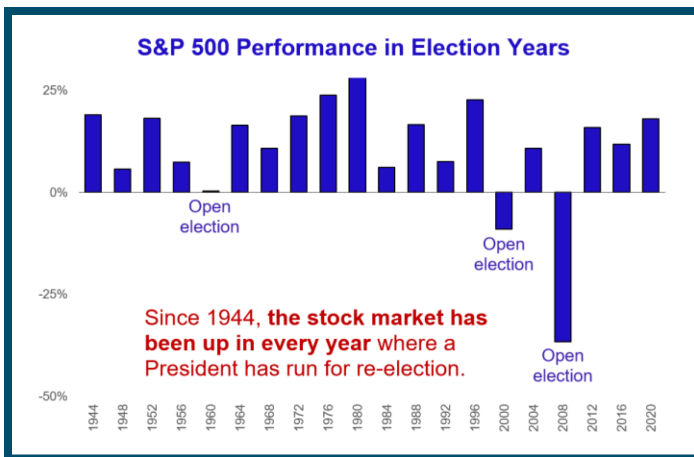
Retail spending could have fallen off a cliff as fiscal stimulus dried up, but the continued strength of the U.S. labor market has kept consumers in solid financial standing. Wage growth is above pre-Covid levels (though cooling), nonfarm payrolls continue to expand, and weekly jobless claims and the unemployment rate remain quite low relative to history. Weekly initial claims are one of the highest frequency indicators we have for the labor market, and will be critical to sniffing out any cracks in the labor market picture that could portend a broader economic slowdown. But the employment situation remains an asset in our books for now.



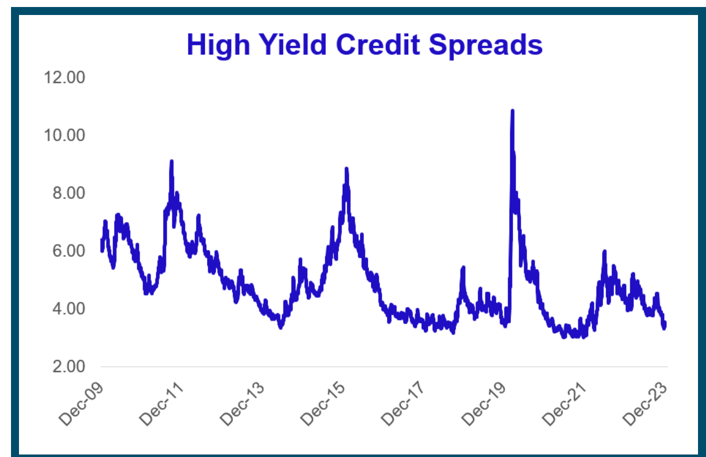
One of the final fronts in the war on inflation is housing prices, where structural demand is meeting a shortage of homes after a decade of underbuilding. Therefore, the level of new building will be critical in rightsizing the supply–demand imbalance and assisting both the Fed and the consumer with high housing prices. In November, U.S. housing starts surged +14.8% from October. We're now accumulating signs of a bottom forming in interest-rate sensitive sectors (which were quite weak in 2022 and 2023) as rates have moderated in recent months. U.S. housing data has leading indicator properties for the economy that we are monitoring closely.



Core PCE just fell back below both the Federal Reserve's 2.0% target and the reading's own 30-year average, Core PCE is the Fed's preferred inflation gauge due to its exclusion of volatile food and energy categories and its more accurate reading of where consumer dollars are actually heading. Inflation remains a concern—housing prices are proving sticky, energy prices could easily reaccelerate on geopolitical turmoil, and second waves of inflation are historically common—but the noticeable downshift in inflationary pressure is a primary reason the Fed feels comfortable shifting towards easing in 2024.



Stocks tend to do well in election years, and particularly in presidential re-election years. On a total return basis, the S&P 500 has increased in every presidential re-election year since 1944. We believe this happens because presidents understand that the economy has an outsized impact on their chances of re-election so they try to prime the economic pump ahead of the election. Unsurprisingly, stocks have responded favorably to this kind of activity. In fact, every president that has avoided a recession two years before the election has gone on to win re-election, and every president who had a recession in those two years went on to lose.



Credit spreads (how much a corporate bond yields compared to a Treasury of comparable maturity) have inched lower from their recent peak. Much like at the start of 2023, the market for risk assets is pricing in quite a bit of economic strength—closer to "robust growth" than "soft landing." Still, baseline spread levels should be higher in 2024 vs 2023, as supply issues, soft landing weak spots, and profit margin compression in some areas put upward pressure on spreads. The default rate on high yield bonds has risen over the last two years to something resembling pre-Covid levels. But of course, interest rates and inflation are much higher today.

S&P 500 Index (Large Cap / U.S. Stocks): A representative sample of 500 leading companies in leading industries of the U.S. economy. These are equity securities of large capitalization (generally $7 billion plus market cap) companies having growth and value characteristics. ● **Russell 2000® Index (Small Cap / Small Core):** Measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represent approximately 10% of the total market capitalization of the Russell 3000® Index. These are equity of small capitalization.● **MSCI EAFE Index Net (International / Developed Markets):** A free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada. As of May 27, 2010 the MSCI EAFE Index consisted of the following 22 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom. ● **BBgBarc Aggregate Bond Index (Taxable Bonds / Bonds):** Comprised of approximately 6,000 publicly traded bonds, including U.S. Government, mortgage-backed, corporate, and Yankee bonds with an average maturity of approximately 10 years. ● **BBgBarc Muni Bond Index (Municipal Bonds):** Bonds must have a minimum credit rating of at least Baa, an outstanding par value of at least $3 million, part of a transaction of at least $50 million, issued after December 31, 1990 and have a year or longer remaining maturity ● **FTSE 3-month T-bill Index (Cash):** This index measures monthly return equivalents of yield averages that are not marked to market. It consists of the last one-month and three-month Treasury bill issues, respectively. ● **Bloomberg Commodity Index (Commodities):** Composed of commodities traded on U.S. exchanges, with the exception of aluminum, nickel and zinc, which trade on the London Metal Exchange (LME). Subindices include Petroleum, Grains, Industrial Metals, Livestock, Precious Metals, and Softs.

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