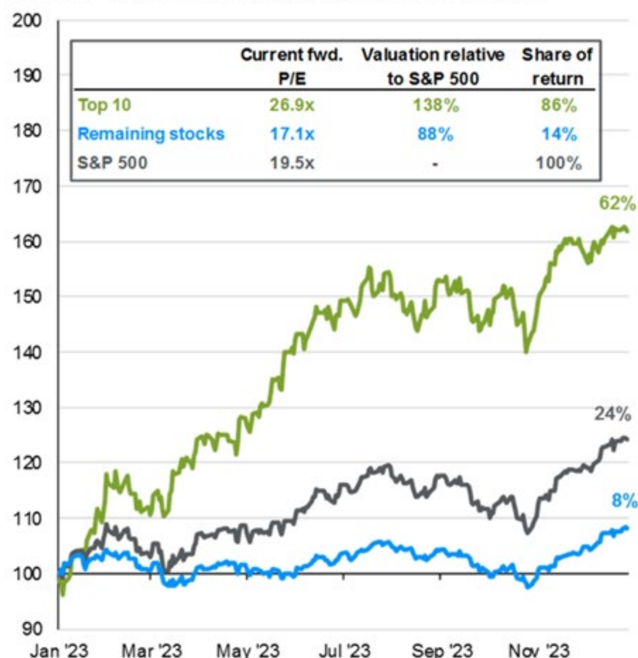
THE WAITING

This past year was not defined by the pandemic as years past, but rather by a volatile mix of bank failures, artificial intelligence hype, wars in the Middle East and Europe, and the impending doom of a recession that never happened. The "long Covid" effects on the economy, mainly in inflation, labor markets, and consumer spending habits, began normalizing to various degrees, ultimately influencing the Federal Reserve to imply that an economic soft landing is in reach. It's safe to say that Tom Petty was not referencing inflation or investing in *The Waiting*, but the waiting has been the hardest part for various market participants this year (although year-over-year inflation remained stubbornly high at 9.8% in May 1981 when the song was released). Economists were waiting for a 2023 recession and Wall Street strategists were waiting for equity markets to undercut the October 2022 lows. Investors were waiting for the S&P 500 to finally rebound to its January 2022 high, as bear markets that do not include a recession have historically required only 11 months to recover[i]. Although consensus suggested a market downturn or recession in 2023, this analysis did not anticipate a technology led equity market in the face of rising interest rates and underestimated the great American consumer and resilient U.S. labor market.



The S&P 500 finished 2023 up 24.2%, which was fueled by mega cap technology stocks for most of the year. The hype around artificial intelligence possibilities negated the litany of other market concerns, driving the Nasdaq higher by 43.4% (albeit the Nasdaq gave up 33.1% in 2022, highlighting the importance of patience and remaining invested). The concentration of the top ten stocks in the S&P 500 is now at an all-time high of 32.1%. Even more impressive, the combined market capitalization of the "Magnificent Seven" (Apple, Microsoft, Alphabet, Amazon, Nvidia, Tesla, and Meta) is now larger than that of all stocks from Japan, France, China, and the U.K. combined[ii]. This chart illustrates the incredible disparity in performance of the top ten and bottom ~490 stocks in the S&P 500, in addition to the index itself. The top ten stocks accounted for a staggering 86% of 2023 S&P 500 gains last year, while the bottom ~490 still had a negative return through October[iii].

The S&P 500 Equal Weighted Index finished 2023 up 11.6% and all gains came within the last two months of the year. This dramatic increase in market breadth occurred as the 10-year Treasury retreated from 5.0% in October to 3.88% at year-end. The possibility of a soft landing, or a drawdown in inflation without a recession, became more realistic for investors, driving equity prices higher across the board but specifically in cyclical sectors like Financials, Industrials, and Consumer Discretionary. Adding fuel to the rally, Fed Chair Jerome Powell delivered dovish comments at the Fed's December meeting by acknowledging the possibility of cutting interest rates, instead of further increases, in 2024. The Fed held its benchmark rate steady at 5.25% – 5.50%, and while the possibility of further raises remains, the last hike likely came last July. As inflation has fallen faster than expected, Chair Powell acknowledged the risk of causing unnecessary harm to the economy by keeping rates high against falling inflation. Notably, Fed officials currently anticipate three rate cuts this year, or a Fed funds rate of ~4.6% by year-end 2024.

Although not all consumers had the same experience, in the big picture, the consumer stress that was emphasized by many economists did not materialize. Consumer spending was the most significant driver of Q3 U.S GDP growth, which grew at a 5.2% annualized rate, or the fastest pace in nearly two years. This does not capture the end of the student loan moratorium in October; however, student loans represent less than 10% of outstanding consumer liabilities, and several retailers recently expressed better than expected holiday spending. U.S. GDP is forecast to have grown 2.2% in Q4, which is in line with the first two quarters of the year. Americans have not been as sensitive to interest rates as expected, as many locked in low interest rates on their mortgages, typically their largest liability. Notably, wage growth, as measured by average hourly earnings, has been above inflation, as measured by the consumer price index (CPI), since May. The trend continued in December, with year-over-year wage growth of 4.1% versus CPI of 3.4%. Additionally, retail sales climbed 4.1% year-over-year in November, compared to November CPI of 3.1%, suggesting lower inflation is not due to a weakening consumer.

The risks of an overheated labor market, or conversely, one that suffered under the Fed's tightening campaign, have abated so far. An unemployment rate greater than 5.0% did not materialize as economists suggested, as this rose from an historically low level of 3.4% to just 3.7% at year-end. The U.S. economy added 2.7 million jobs in 2023, which was a slowdown from 2022 of 4.8 million, but much higher than the several years preceding the pandemic. An increase in the number of available workers has been key to cooling the labor market while maintaining growth. The overall prime age participation rate (25 – 54 years old working or seeking work) finished the year at 83.2%, which is the highest level since 2008, and was led by the return of women to the work force whose participation rate is near all-time highs. Additionally, immigrants' share of the labor force continues to climb and ended the year at nearly 19%. Immigrants remain a critical buoy to the U.S. workforce and their contribution is key for future growth[iv].

Although an economic or market downturn didn't materialize in 2023, it is possible that the waiting has just not been long enough, and this will be a focus for 2024. It is arguable that the lagging effects of monetary tightening have not fully impacted corporations and commercial real estate, or that elevated consumer spending will not continue to bolster GDP growth. Inflation may prove to be stickier at these levels or could even move higher with the unpredictability of ongoing geopolitical issues. This could deter the Fed from cutting rates as fast as the market anticipates, thus pushing short-term rates higher. Despite all the other market noise, equity markets have been dependent on interest rate movement, and higher short-term rates would likely send equity prices slower. Equity prices also assume double digit earnings growth for 2024, which may not be achievable in a slowdown, thus some stock valuations at current levels may not be supportable. Altogether, it is reasonable to expect market turbulence this year, and short-term price fluctuations may present investment opportunities. This also calls to mind some quotable wisdom from the late Charlie Munger, former vice chairman of Berkshire Hathaway and Warren Buffett's right-hand man, who recently passed away at 99 years old: "The big money is not in the buying and the selling but in the waiting." This means establishing a strategy, remaining invested during bouts of volatility, and avoiding impulsive trading to "time" the market in futility. Investing requires patience and discipline, and the waiting can be the hardest part.

[i] Fidelity Viewpoints
[ii] MSCI; Allspring Global Investments
[iii] J.P. Morgan Asset Management
[iv] U.S. Bureau of Labor Statistics

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