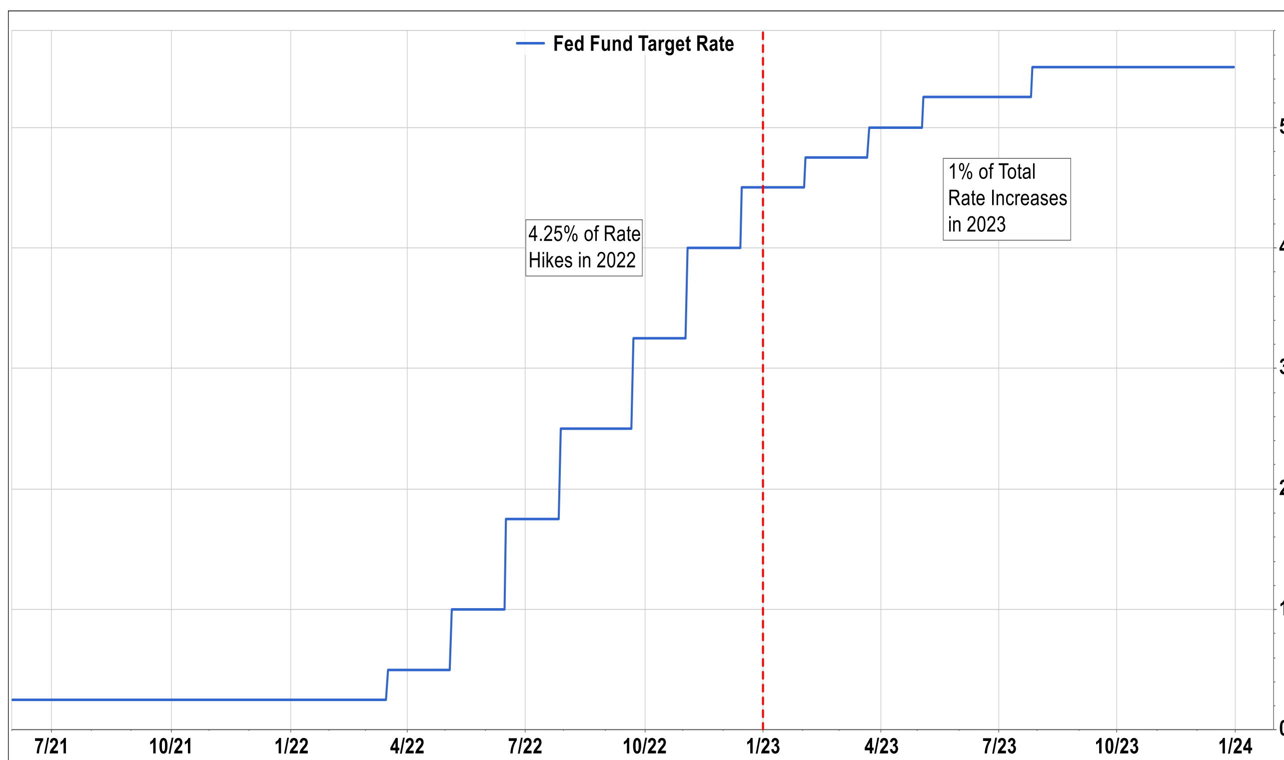
## 2023 Economic Review – The Federal Reserve

During Alan Greenspan's tenure as Federal Reserve Chairman, CNBC started to analyze the thickness of the briefcase Greenspan would carry into the Federal Open Market Committee meetings. They advanced the notion that an interest rate decision could be deciphered ahead of time based on the number of papers that Greenspan was carrying into Fed rate decision meetings. This began to be referred to as the "briefcase theory." If the briefcase was full, it indicated that Greenspan was bringing evidence to the meeting to support a rate increase. If the briefcase was thin, then there would likely be no change to rates. As peculiar as this sounds today, during most of the organization's history, the Federal Reserve was largely secretive regarding its actions. This could not be further from how the Fed acts and communicates today. Rarely does a week go by where a Fed governor is not being interviewed by financial news pundits. The common message from Fed officials throughout 2022 was their "higher for longer" interest rate policy. In no unclear terms, the Fed signaled that there would be additional rate hikes.

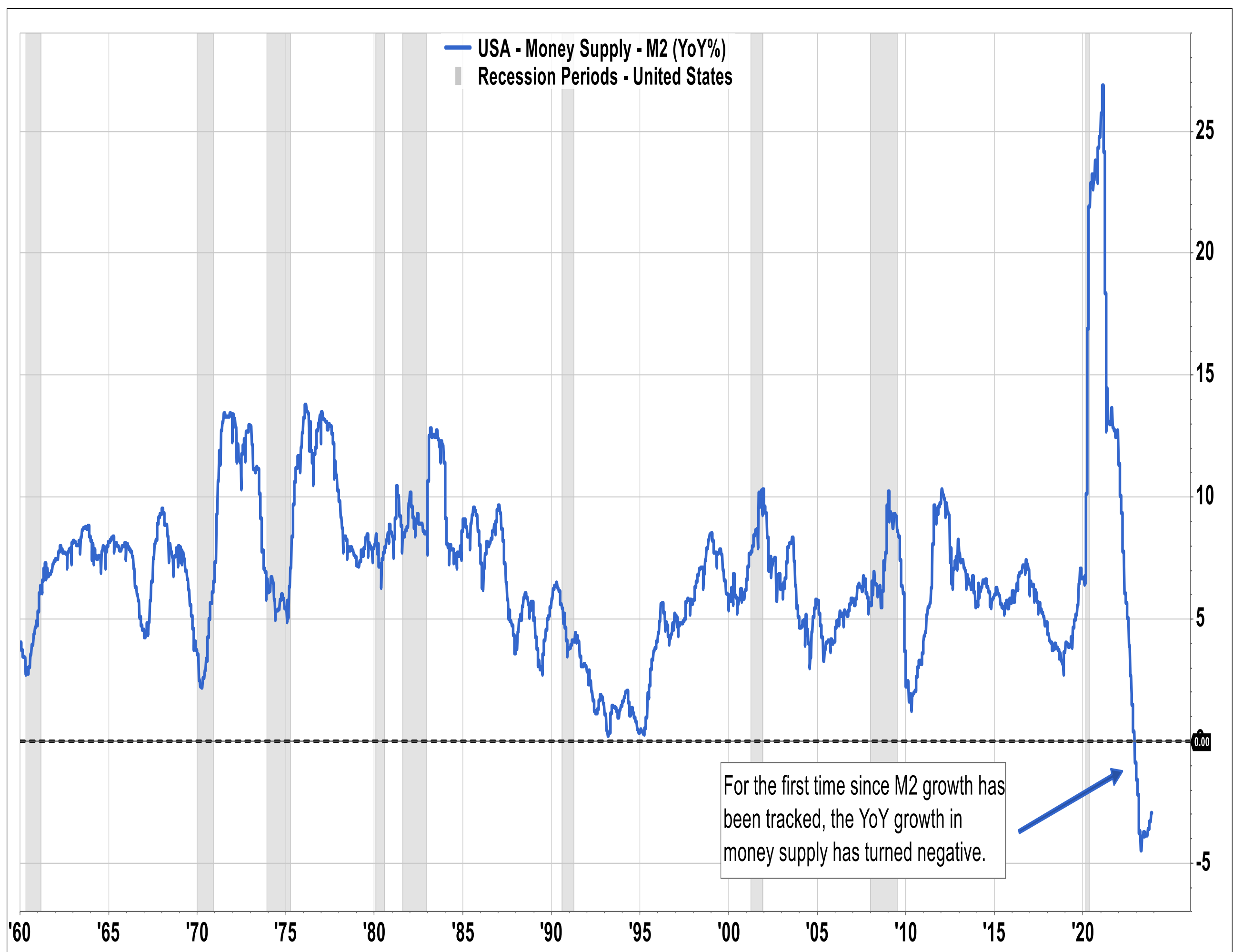
Without much surprise, the Federal Reserve continued their tightening cycle in 2023 with an additional four, 25 basis point interest rate increases. When combined with the seven interest rate hikes in 2022, the upper bound of the Federal Funds Rate ended the year at 5.50%.




The last time the Federal Funds Rate was this high, George W. Bush was in the early innings of his first term, and the "Dot Com" bubble was in the process of bursting. But it was in the wake of the 2008-09 financial crisis that the economy and the markets became accustomed to a sub-2% interest rate environment. In fact, for much of the 2009-2015 period, the federal funds rate held at or near zero. Most of the readers of the "Outlook" will recall interest rates historically have been at levels that are significantly higher than the current 5.5%. The notable part of the current interest rate hiking cycle is not the absolute level of rates, but

the speed at which they were reached.  This has been the fastest increase in the Federal Funds rate since 1981 when Paul Volcker was credited with ending the rampant inflation of the late 1970's.

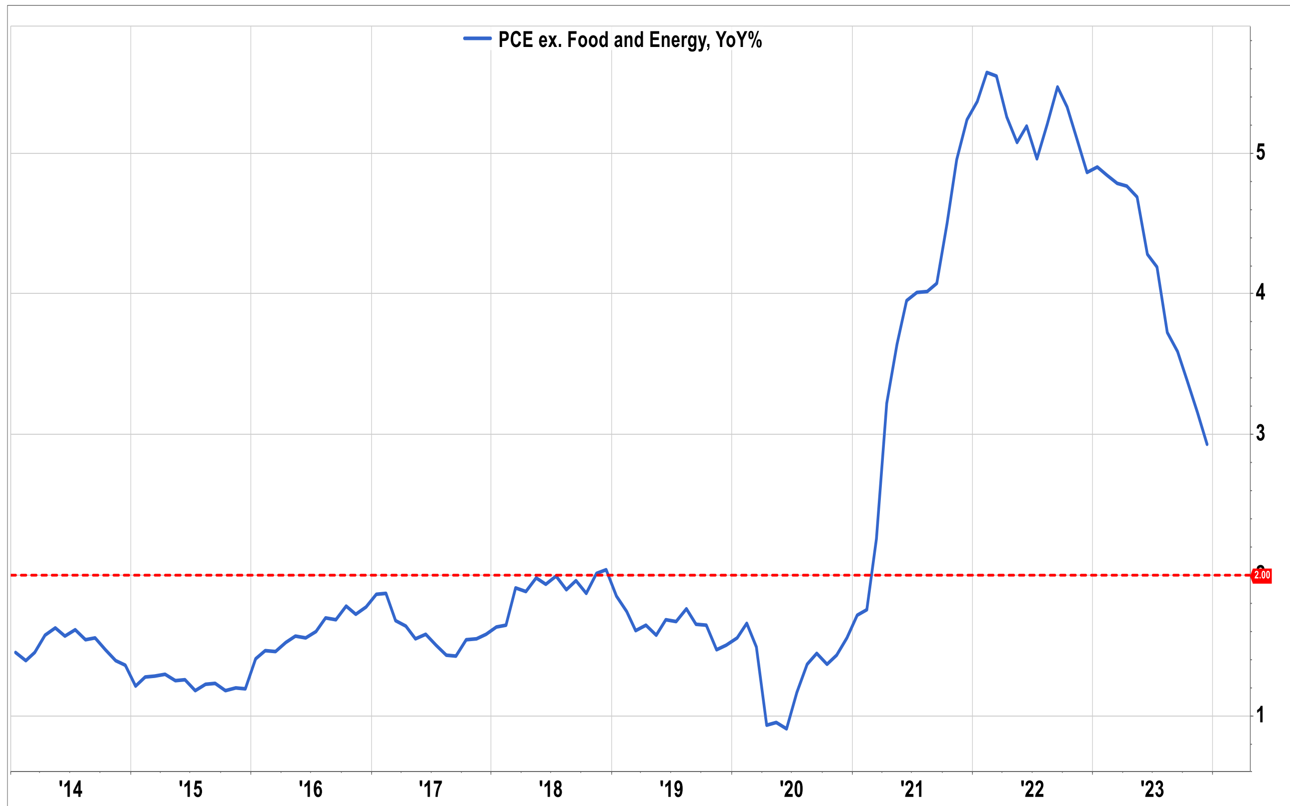
On a somewhat less reported basis compared to interest rate hikes, the Federal Reserve was also engaging in quantitative tightening (QT) during 2023.  They were allowing the bonds that had previously been purchased in order to simulate the economy to mature and roll off their balance sheet.  This has a similar effect on the economy as interest rate hikes.  From the peak in 2022, the Fed decreased the size of their balance sheet by $1.3 trillion.  While this seems like a staggering figure, it needs to be viewed in the context of the expansion of the balance sheet in response to the COVID recession.  From the start of 2020, the Federal Reserve grew its balance sheet by almost $5 trillion. This means that the balance sheet has declined by about 25% of the total increase that was attributable to the pandemic-induced quantitative easing.  The goal of these combined policies was to create restrictive monetary conditions in the economy, and the Federal Reserve was able to accomplish this in 2023.  One clear piece of evidence that confirms this restrictive policy is the change in the money supply.  Since the Federal Reserve began tracking nominal M2 money supply in 1959, there has never been a time where the money supply declined on a year-over-year basis.  That long-standing trend was broken last year when the money supply declined by 4.5% at the low point in April.




It is always significant when there is a "first" in a series of economic data, but in this particular case, it has to be acknowledged that this decline was immediately preceded by the largest increase in history.

## Inflation – It Ain't Over til It's Over

Inflation finally began to subside during 2023 as result of aggressive measures taken by the Federal Reserve. All throughout 2021 and into the early parts of 2022, the Federal Reserve referred to the rise in the inflation rate as "transitory." This belief was founded on the notion that the inflation was stemming from supply chains disruptions that were combined with the massive fiscal and monetary policy responses to the pandemic. The Fed therefore believed that the inflation would naturally subside on its own once the economy reached a new state of equilibrium. We have the advantage of hindsight to tell us that this wasn't the case. Core PCE, the Fed's preferred metric, peaked at 5.6% and has now retreated to 2.9% based on the December report.




Even though there has been a significant improvement in the rate of inflation, the Federal Reserve will likely not be taking a victory lap any time soon. The Fed has reiterated that they are committed to bringing inflation down to their long-term 2% target. The common rhetoric remains that the final reduction in inflation from 3% to 2% has the potential to be most challenging.

## Unemployment Still at Historic Lows

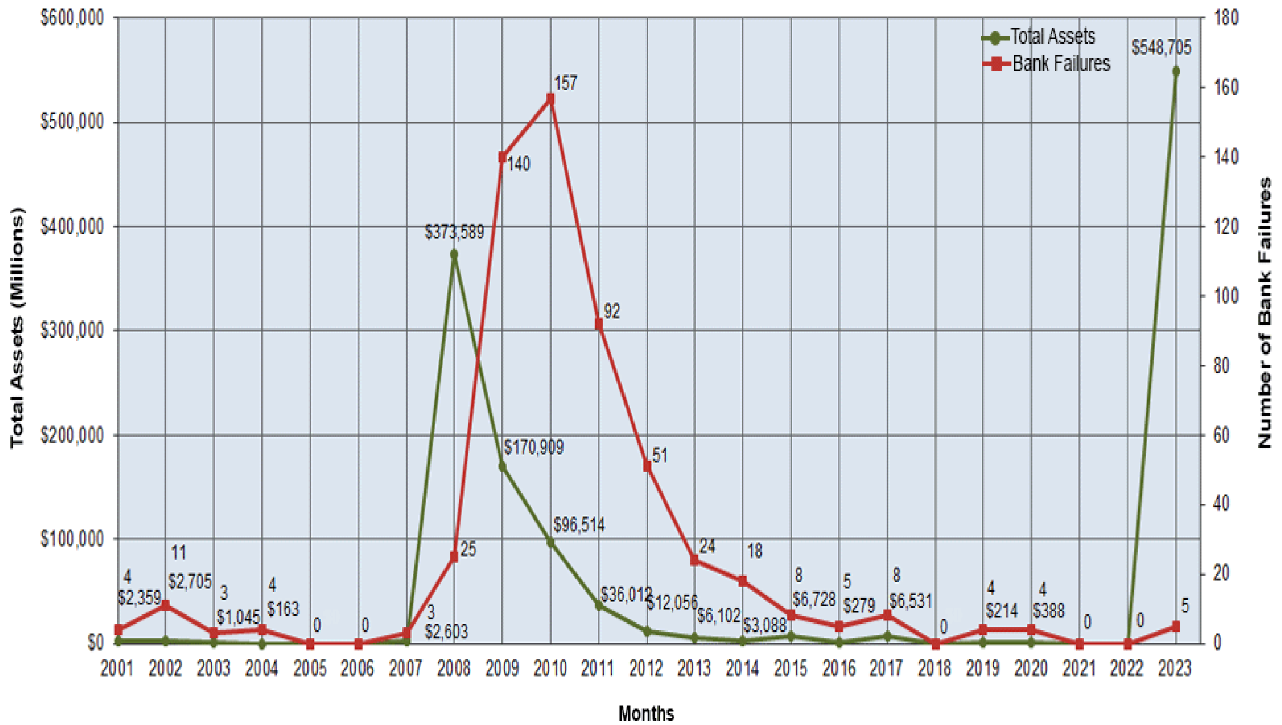
As is the case with any financial tightening cycle, the Federal Reserve walked a fine line in 2023. They are primarily given two major economic tasks: to promote price stability, and to promote full employment. The ironic element is that these two goals tend to oppose each other. The risk that follows bringing inflation down rapidly is that the economy slows, and the unemployment rate moves higher. So far, the Federal Reserve has been successful at reigning in inflation and not causing a corresponding increase in the unemployment rate. Unemployment remained at historically low levels in 2023 with the last reading at 3.7%. When compared to the 30-year average, the unemployment rate is now one full standard deviation below its long term average. That's technical jargon for well outside the norm.

The job market can also be viewed through the lens of the number of jobs that are available compared to the number of unemployed persons. When the labor market was most unbalanced position coming out of the COVID shutdowns, there were two jobs available for every person who was seeking employment. That ratio has now declined to 1.4 jobs that are available per unemployed person. We are not yet back to the pre-pandemic levels of 1.2 jobs, but it does provide evidence that some balance has returned to the labor market.

## **Bank Failures Rose, But the System Survived**

At the surface level, it would appear that the Federal Reserve was able to" have their cake and eat it too" in 2023. Inflation cooled and there was no corresponding rise in the unemployment rate. However, it would not be entirely accurate to say that there were no consequences to the Fed's financial tightening cycle. Three major regional banks failed in 2023 at least in part due to the changes in monetary policy.

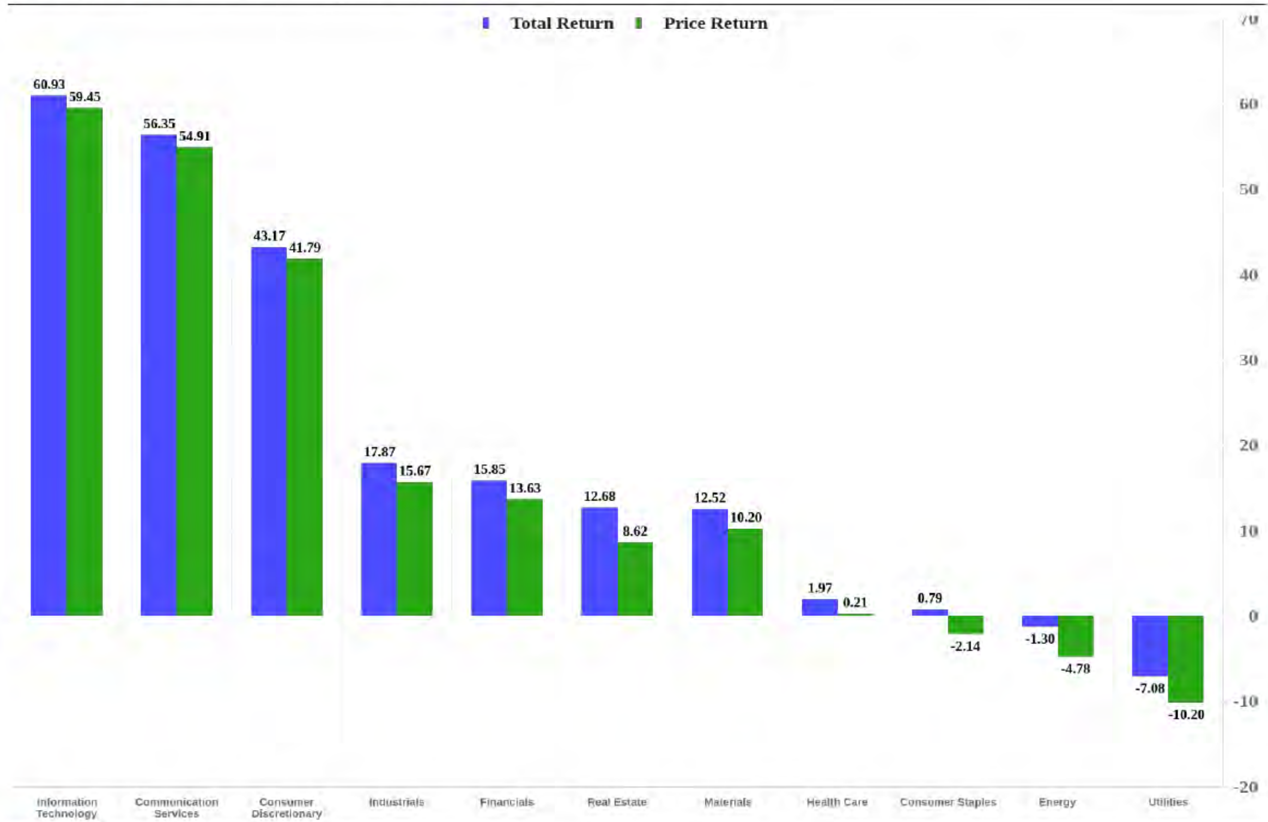
Silicon Valley Bank, Signature Bank, and First Republic Bank all failed in the first half of the year. These banks in total had assets that exceeded $550 billion, and are now the second, third, and fourth largest bank failures in US history. Only Washington Mutual, which failed during the financial crisis of 2008-09, had a larger balance sheet than the banks that failed in 2023. Over the last several years, bank failures in the United States have become quite rare, but there have been 566 bank failures from 2001 through 2023. It is not remarkable that banks failed last year, but it is the size of these banks that make it historic. Almost half of the assets that were involved in bank failures since 2001 were attributable to 2023. Even more startling, if all the assets from bank failures during the financial crisis of 2008-09 are totaled, they do not equal the assets of the banks that failed in 2023.




The catalyst, in part, for these bank failures was the rapid rise in interest rates. These banks had purchased long duration bonds when rates were at historic lows with the large influx of deposits that were received during the COVID stimulus. When interest rates spiked, the value of their bond portfolios plummeted, and they struggled to return customer deposits. Once the confidence was lost in these banks, it was only a short time before they ultimately failed.

## Equity Markets Review

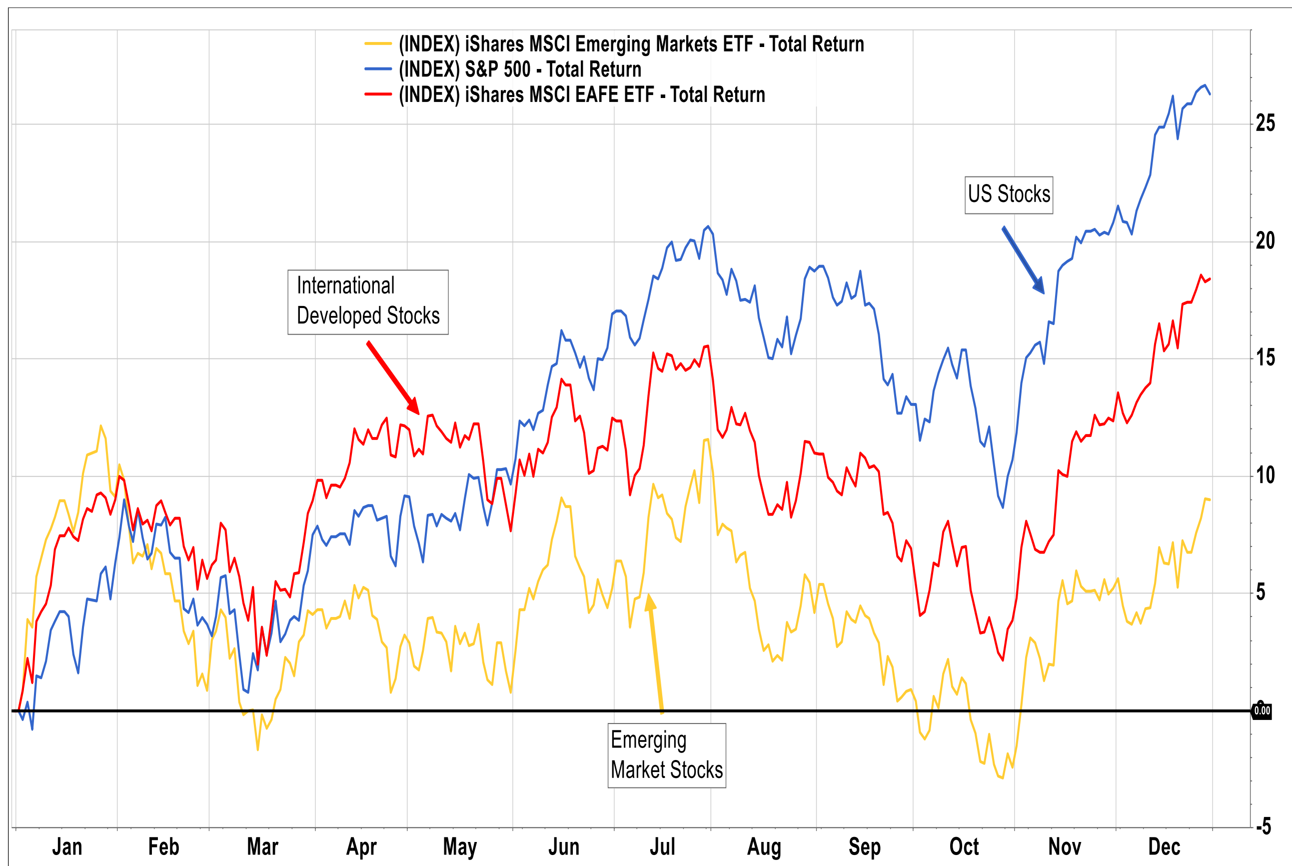
Even with 2023 marking the largest number of bank failures since the financial crisis, equity markets charged ahead in 2023. The S&P 500 posted an impressive 24.3% price-only return, and when dividends are included, generated a 26.3% total return. It must be noted that the S&P 500 has become increasingly concentrated over the last several years, a feature commonly seen in the late stages of a bull market. Mega-cap technology stocks now make up a large portion of the index, and this concentration hides movements in the broad market that are no longer visible at the headline index level. This was the story of equity markets in 2023. When the S&P 500 is viewed on a sector basis, there were only three sectors out of eleven that outperformed the S&P 500: Technology, Communication Services, and Consumer Discretionary.




Just seven large growth stocks, now referred to as the Magnificent 7, accounted for about 80% of the S&P's return last year. Each of them – Apple, Amazon, Alphabet (Google), Microsoft, Nvidia, Meta (Facebook), and Tesla - resides in one of those three sectors. The more defensive and value-based areas of the market actually generated negative returns during the year. The growth-oriented areas of the market outperformed value stocks by a margin of almost 45%. To say that the market rally in 2023 was narrow would be a vast understatement. When the S&P 500 is presented on an equal-weighted basis, as opposed to market-cap weighted, the inordinate impact of those Magnificent 7 stocks is removed. There were significant periods of time during the year when the equal-weighted index generated negative returns, while the cap-weighted index had generated close to double-digit returns. **Based on that disparity, it's not surprising that 72% of stocks in the S&P 500 underperformed the index last year, and the equal-weighted index generated less than half the return of the cap-weighted S&P 500.**

The leadership of the mega-cap technology stocks also meant that U.S. small-cap and mid-cap stocks underperformed the S&P 500 by a wide margin. This is somewhat ironic because small and mid-cap stocks tend to exhibit a higher level of volatility compared to large-cap stocks, and thus are expected to generate higher returns over a full market cycle. While we have not completed a full market cycle, small-cap stocks face a high hurdle if they are going to match their historical higher returns compared to large cap stocks. Since the start of 2020, the S&P 500 has outperformed small-cap stocks by a margin of close to 30%. It must also be noted that small-cap stocks were not able to recoup their losses from 2022 last year as they ended 2023 still 7% below their starting level of 2022.

While it may seem like belaboring the point, the dominance of the S&P 500 driven by the performance of the Magnificent 7 was evident when viewed against international markets as well. The S&P 500 outperformed international developed stocks by 8% and outperformed emerging market stocks by 17%.

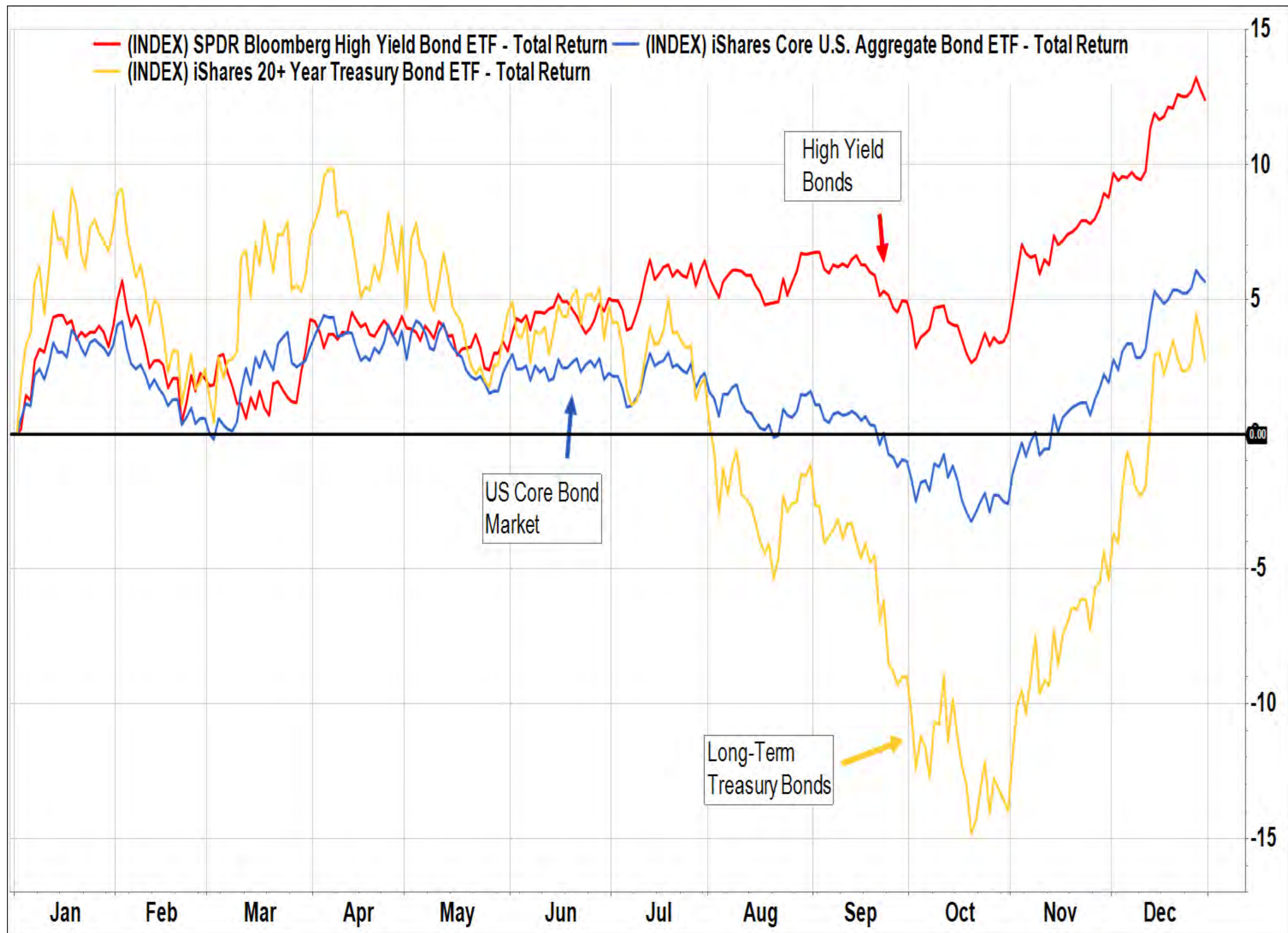



When viewed from the start of 2020, the S&P has now outperformed international developed stocks by 35% and emerging markets stocks by more than 59%. This means that emerging market stocks have actually generated a negative return over that time period. Similar to small cap stocks, emerging markets are generally forecasted to offer higher potential rates of return compared to domestic large cap stocks. However in this case, it wasn't that emerging markets generated a smaller positive return, but generated no return at all!

When discussing the equity markets, the focus is almost always on the returns that are generated, but the volatility that is present in the market is as equally important. The CBOE Volatility Index (VIX) remained well below the 10-year average during 2023. The markets have not experienced this level of sustained low expected volatility since 2017. This is in contrast to 2022 when the expectation for volatility remained elevated above the average for the enter year, and for much of the year was a standard deviation above the average.

**Fixed Income Review**

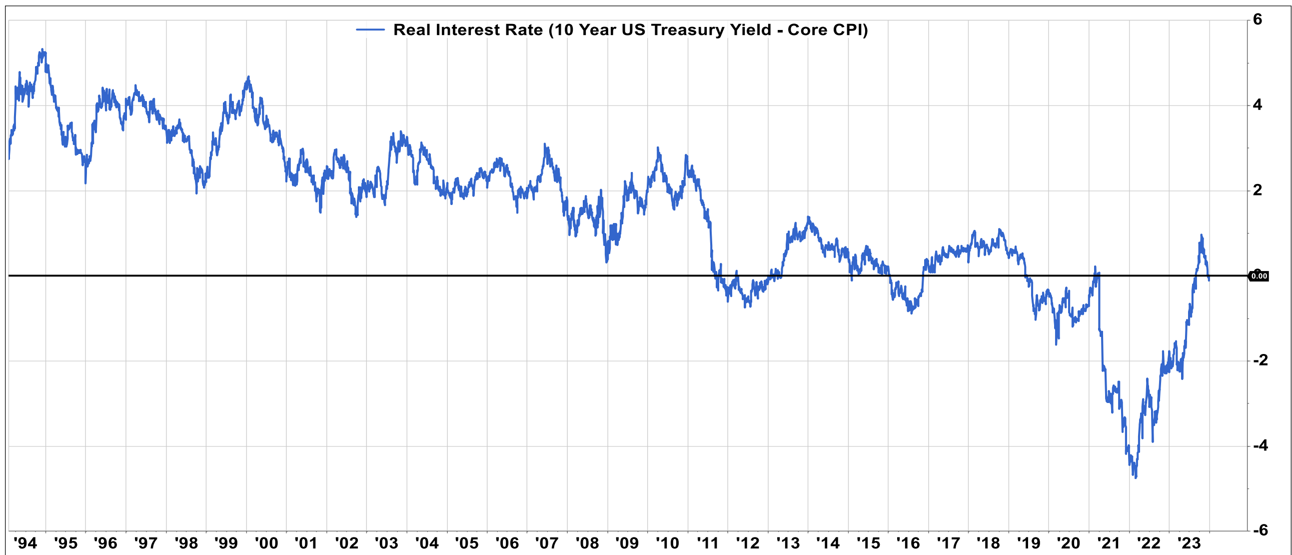
After 2022 when fixed income investors suffered their worst losses in history, 2023 provided a measure of relief with positive returns. The Bloomberg US Aggregate Bond Index generated a 5.53% return. The high yield markets outpaced investment grade bonds with a 13.5% return, and long-term treasury bonds also managed to post a small positive return for the year.




Even though these were favorable results, investment grade bonds have still generated a -4.19% annualized return over the last two years. In fact, you need to go back 5 years to find a starting point for a period in which bonds have generated a positive annualized return. High yield bonds on the other hand, the riskier area of the fixed income market, have generated an annualized 5.21% return over the last 5 years.

Even though it was a positive year for fixed income markets, it was nevertheless a highly volatile year. The 10-year U.S. Treasury yield began the year at 3.88% and in a strange coincidence also finished the year at exactly 3.88%. However, the yield fell as low as 3.3% in April and rose to as high as 5.0% in October. There were 43 trading days where the 10-year Treasury yield moved by 10 basis points or more. This is only three days less than in 2022 when bonds generated a negative 13% return. There has not been this level of volatility in the fixed income markets since the financial crisis.

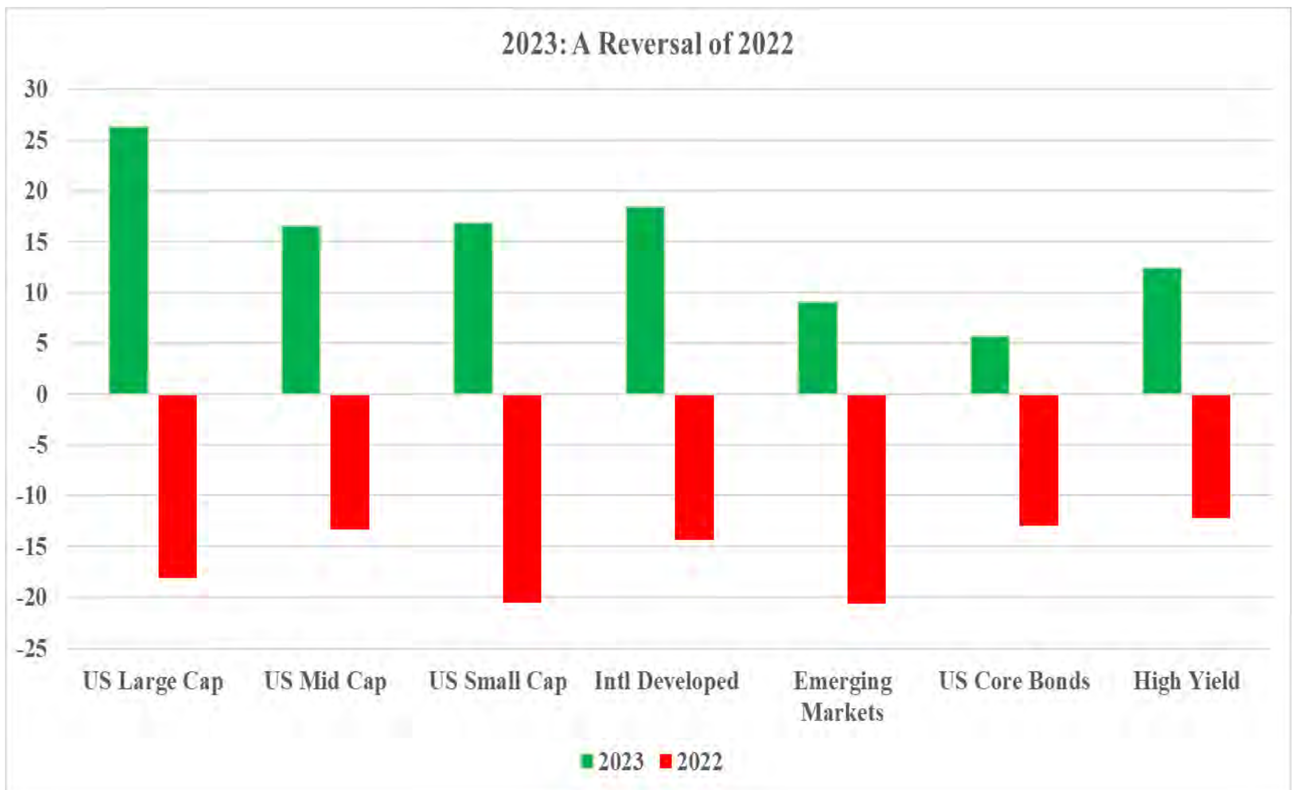
It is not our intention to burst the bubbles of fixed income investors who were pleased to have positive results last year, but it must be pointed out that while nominal yields have risen, *real* interest rates are still extremely low. The 10-year Treasury yield is basically at the level of the core CPI, meaning that the real interest rate finished the year at 0%.




This means that on a yield-only basis, there would be no positive results for fixed income investors after inflation. This 0% real rate is a significant improvement compared to the early parts of 2022 when real interest rates reached a cycle low of -5%. Prior to the 2008-09 financial crisis, real interest rates tended to hover in the range of two and four percent going as far back as the early 1990's.

Investors were able to earn a positive real yield in money market funds though. With government money markets yielding north of 5%, money market fund inflows exceeded $1.2 trillion in 2023. This was the largest annual increase on record, and total money market fund balances now exceed $6 trillion.

There were no major asset classes in 2023 that generated a negative return. This is in stark contrast to 2022 when every single asset class generated a negative return.



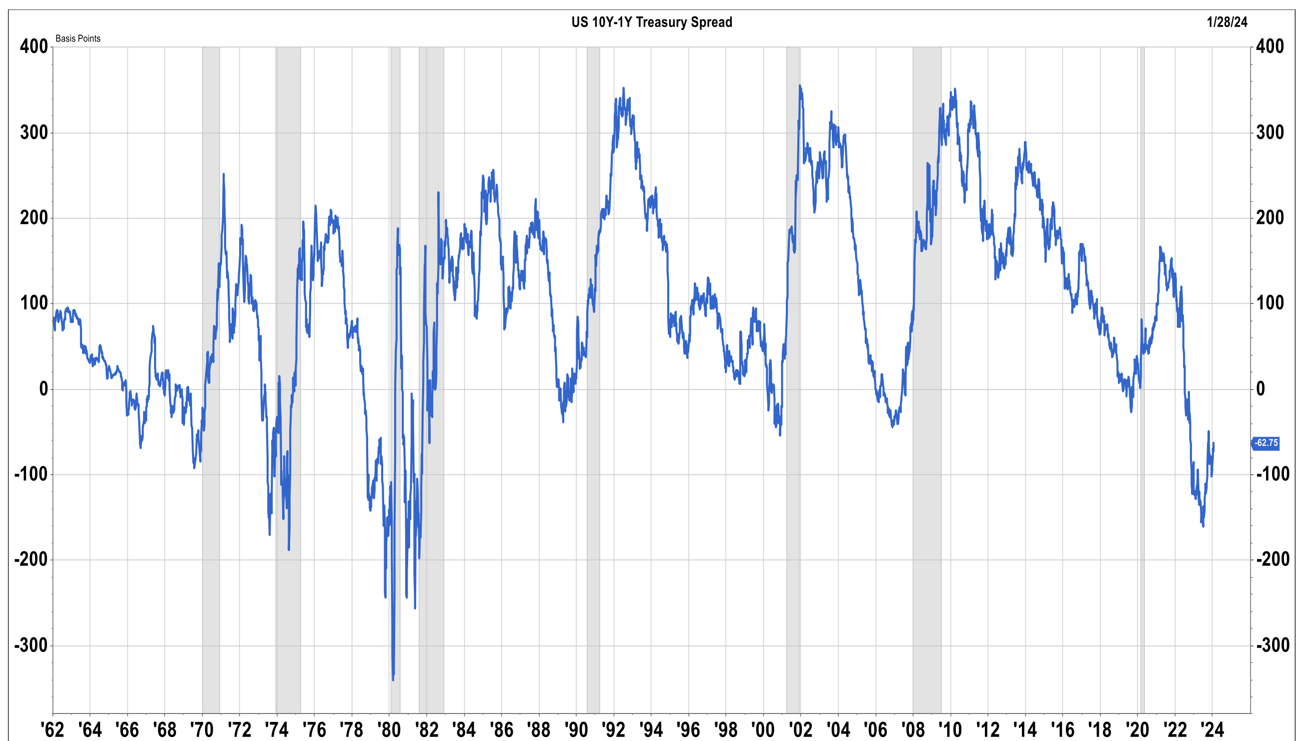
For this reason, 2023 acted as a mirror image to the experiences of 2022. While not every asset class has fully recovered their losses from 2022, they have made a significant rebound. When viewed in the context of a 60% equity portfolio (S&P 500) and 40% bond portfolio (Bloomberg US Agg.), the 18% return that was generated was almost double the average return going back to 1950. And this comes after 2022, which was the third worst year during that same time period. Only 2008 and 1974 generated lower returns than what was experienced in 2022.

There's hardly a year in financial markets where there isn't some unprecedented occurrence and last year was certainly no exception. Even through the narrowness of the equity markets and the volatility in the fixed income markets, it's important to remember that the results of 2023 were significantly better than what had been forecast. The yield curve remained deeply inverted throughout the year and leading economic indicators were consistent with elevated risk of recession. The consensus forecast of investment managers, ourselves included, was that a recession would begin sometime in the 2nd half of the year, the only questions involved its length and severity. Jamie Dimon, JPMorgan Chase CEO, famously stated that an economic hurricane was coming. Ultimately, no hurricane or recession came, despite the warning signs. The economy defied the consensus, providing fair skies and smooth sailing for the capital markets.

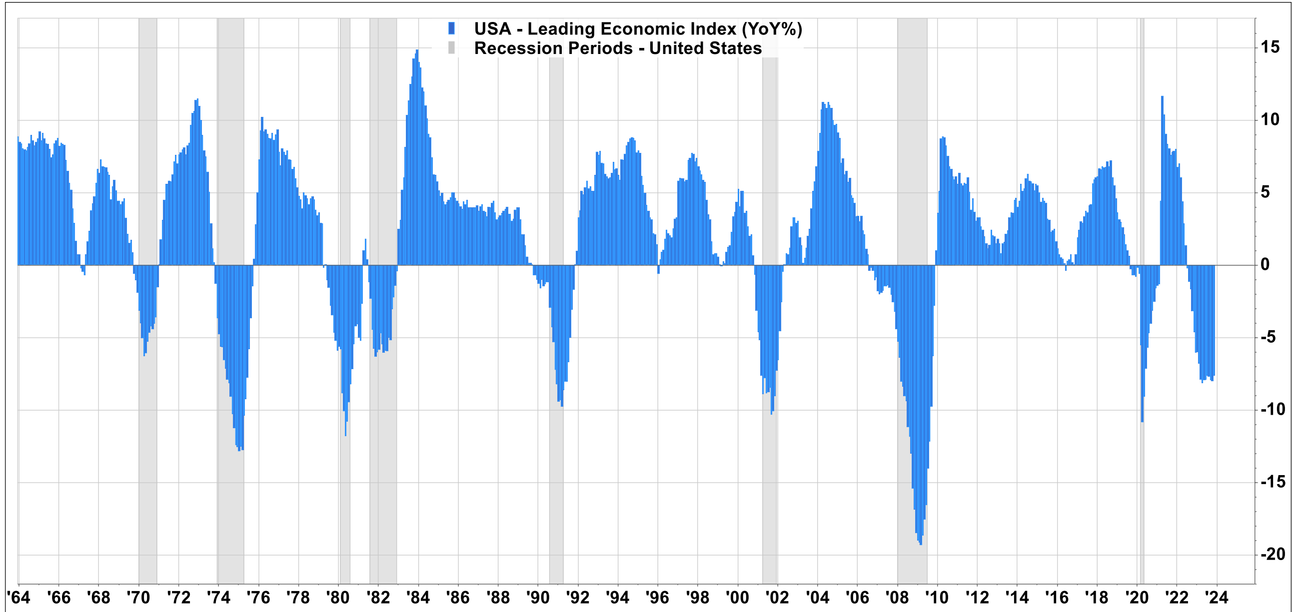
## Leading Indicators Are Still Pointing to Recession

We begin the new year much as we began 2023, with some of the most reliable leading indicators still pointing to a recession.

As we have pointed out in every *Outlook* we have written in the last 18 months, there has not been a single instance in which the yield curve has inverted (short-term rates higher than long-term rates), without a recession ensuing within a period of 6 to 24 months – at least not in the last 50+ years. The current inversion is deeper – and has persisted longer – than any of those we have experienced for the last 40+ years, yet the economic and labor market data continue to surprise on the upside.

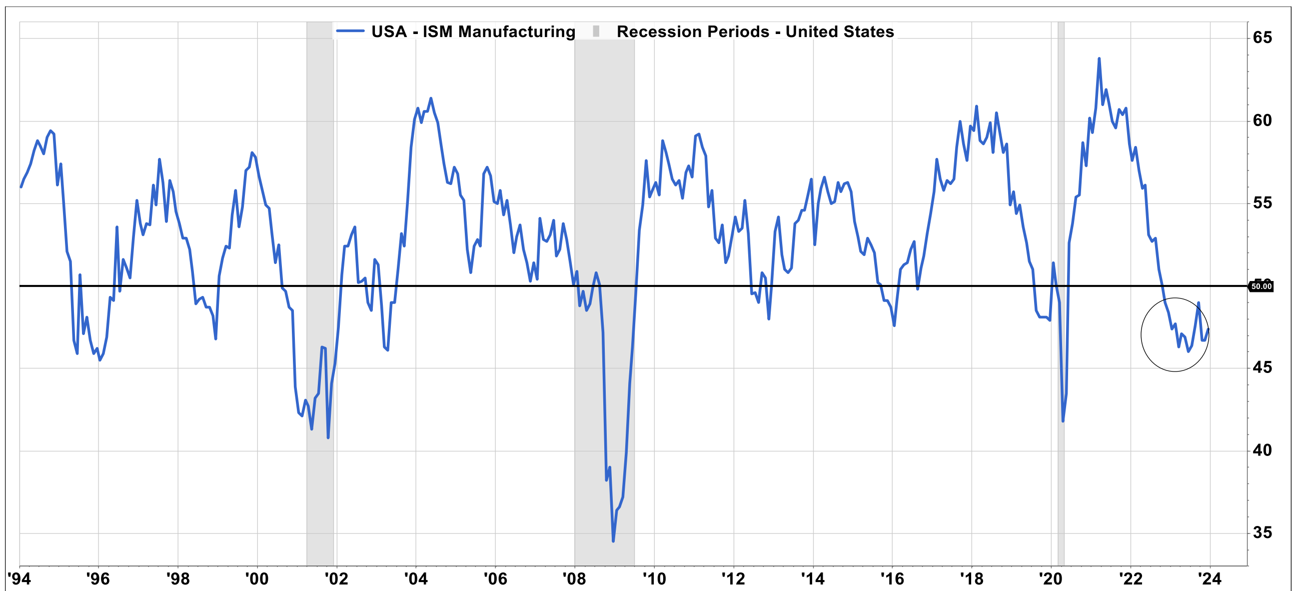


Similarly, the Conference Board's index of Leading Economic Indicators, which includes a wide variety of data on credit activity, consumer confidence, building permits, manufacturing output and other indicators, has descended to a level that has been indicative of recessions in the past, and has remained there for most of the last two years.



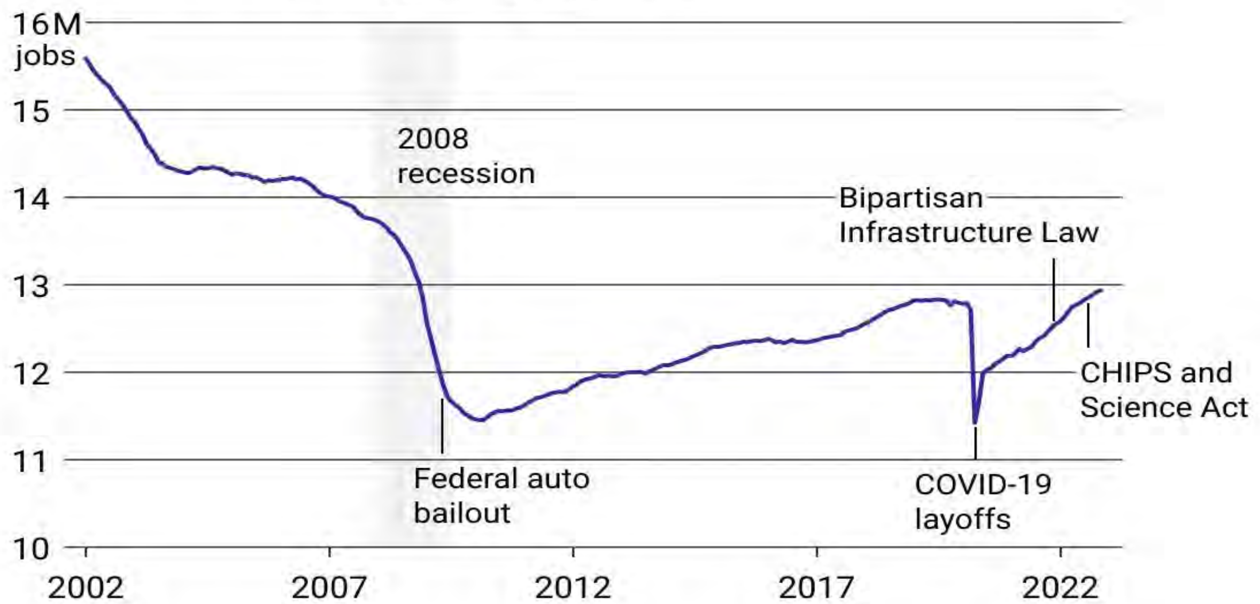

Other leading indicators, however, are either beginning to turn up, or at least require some examination as to why they may be less reliable in the current situation than they have been in the past.

The Purchasing Managers Index (PMI) of manufacturing activity has been below 50 since late 2022, which is indicative of a sector that is contracting. However, this indicator does appear to be bottoming at a level that is above prior recessions. And it is also necessary to point out that this indicator is less useful than it used to be, as manufacturing activity accounts for a smaller percentage of our economy than it used to.

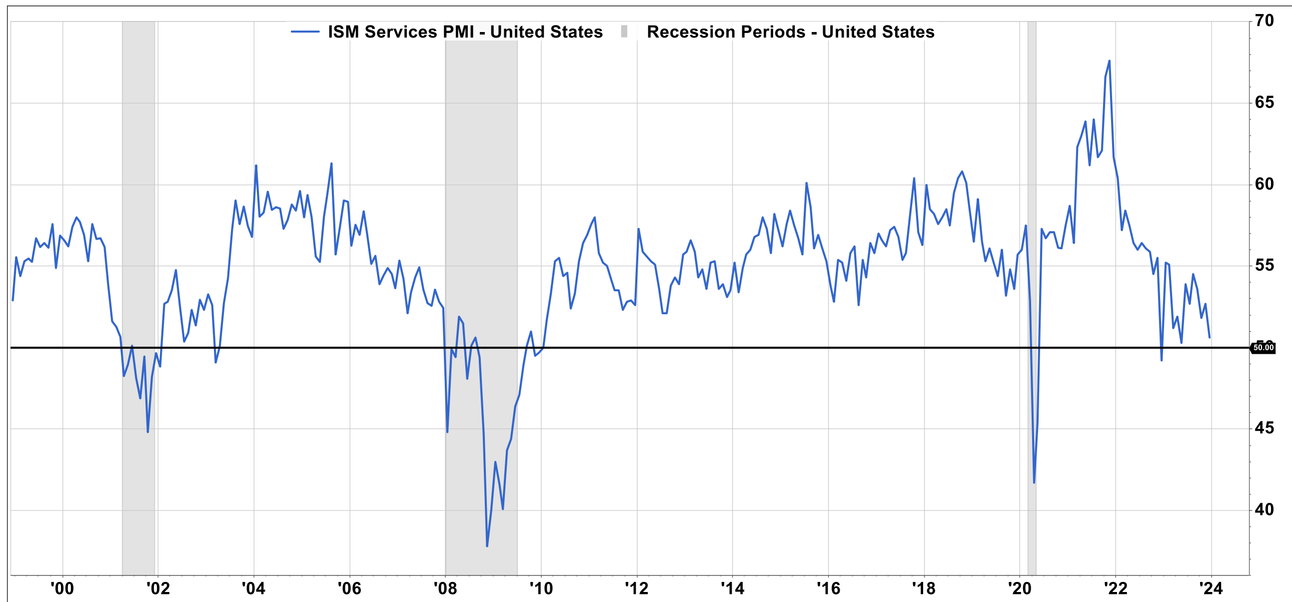


At its peak in 1979, manufacturing provided almost 20-million jobs to the economy. That number fell steadily over the ensuing four decades to a low of just 11-million jobs by 2019. Data for 2020 and later is skewed by the pandemic.

But there is an under-reported and positive twist to the manufacturing story that is beginning to unfold in the wake of the pandemic, and it is that "de-globalization" – or "re-shoring" – is starting to bring manufacturing jobs back to the U.S. The supply chain issues that arose as the economy emerged from the COVID-19 shutdown have made reliability, rather than cost, the major focus for companies when considering their supply chain management. Government has also stepped in with stimulative measures to encourage this trend and, as a result, more than 1.5-million manufacturing jobs have been added to the economy since the bottom of the 2020 recession.




As for the services sector which provides 70% of all non-farm employment in the U.S., its PMI fell sharply from its late 2021 peak, but all measures which began in the COVID period and its aftermath must be viewed critically. The services sector plunged during the mass isolation of 2020, then soared from a low base as schools and restaurants opened again. It was predictable that the pace of the post-recession recovery period was not sustainable, and it has returned to a more normal level and shows no signs of receding.



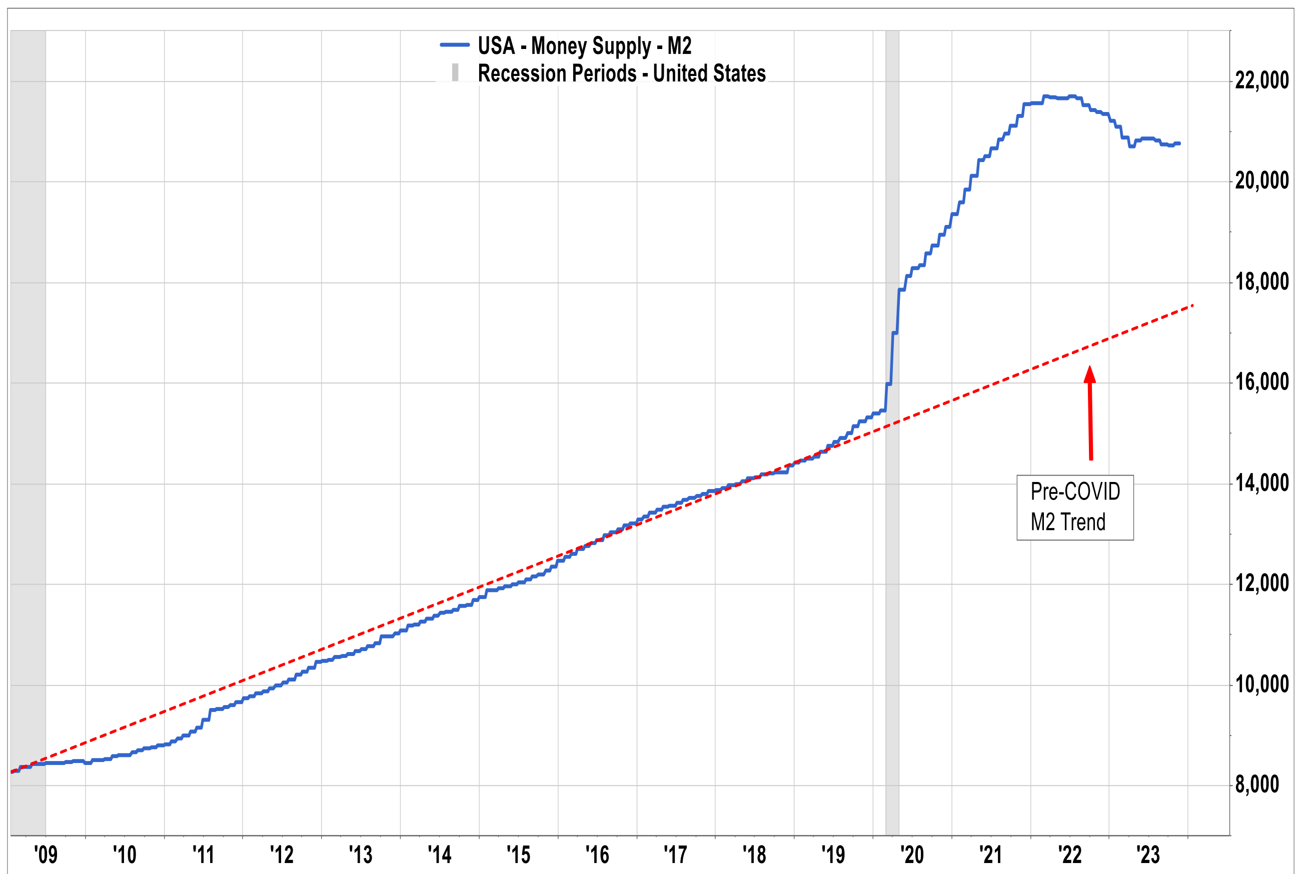

**Real Money Supply (M2) Is Declining – Does It Matter**

If an inversion of the yield curve has historically been the most accurate indicator of a looming recession, economists also look to changes in the monetary aggregates as well. The most widely used measure of the money supply is M2, which includes currency held by non-banks as well as checking and savings deposits, certificates of deposit under $100,000, and shares in retail money-market funds.

Historically, year-over-year declines in M2 have been associated with recessions, although the reliability of this indicator has been far less than that of the yield curve. Nevertheless, many analysts are alarmed at the historic decline in M2 over the last year, noting that it is deeper than any experienced in past recessions.

But as we have noted earlier, all comparisons which have their base in the Covid or post-COVID period must be viewed in the context of that period. Yes, the recent decline in M2 has been historic, but it is nowhere near as historic as the rise in the money supply that preceded it. In 2020 alone, to keep the economy functioning, Congress enacted five measures providing $3.8-trillion in fiscal stimulus in the form of loans, tax and debt relief and direct payments to individuals, businesses and not-for-profits. This does not include the American Rescue Plan ($1.9-trillion) or the Infrastructure Investment and Jobs Act ($1.2-trillion), both of which were enacted in 2021. Altogether, these measures injected $6.9-trillion into a pre-COVID GDP of $21.3-trillion, amounting to a boost to the economy of more than 32%.

Rather than looking at the yearly change in the money supply through a unique period that renders historical comparisons meaningless, we think it is more instructive to look at the actual level of M2 before, during and after COVID. And while the supply of money has indeed declined from its peak, it is still well above its pre-COVID trend, and sufficient to continue to drive the economy for at least a while longer.




**The Government Giveth, and the Government Taketh Away – Eventually.**

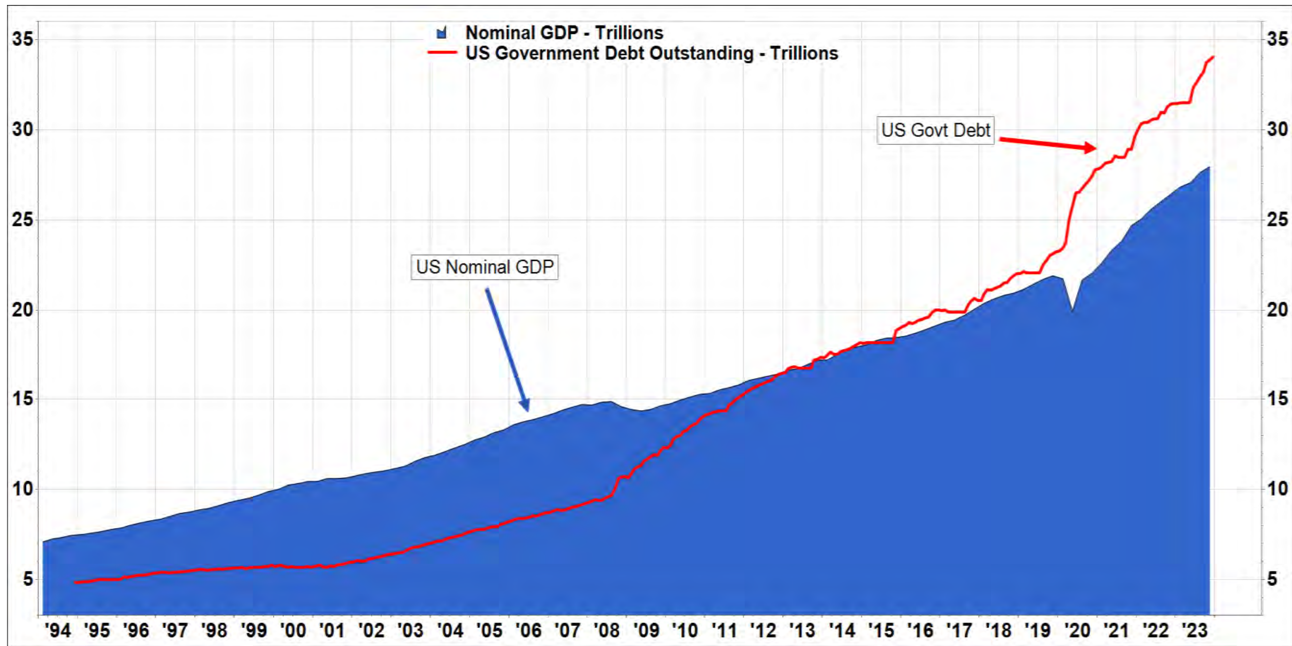
If you have been invested in the market for any length of time, you are familiar with the caveat that the most expensive words you can utter are, "this time is different."

Mindful of this, we have maintained a cautious, defensive approach to managing our clients' portfolios since the yield curve inverted more than 18 months ago. To be fully or aggressively invested in the face of a leading indicator that had not sent a false signal of recession in more than 50 years seemed to us to be imprudent, particularly when most of the secondary indicators were also sending cautionary signals.

But once in a while things are different, and history doesn't always repeat itself perfectly. If there is anything that makes this time different, it is the sheer magnitude of the government's response to the COVID induced economic shutdown.

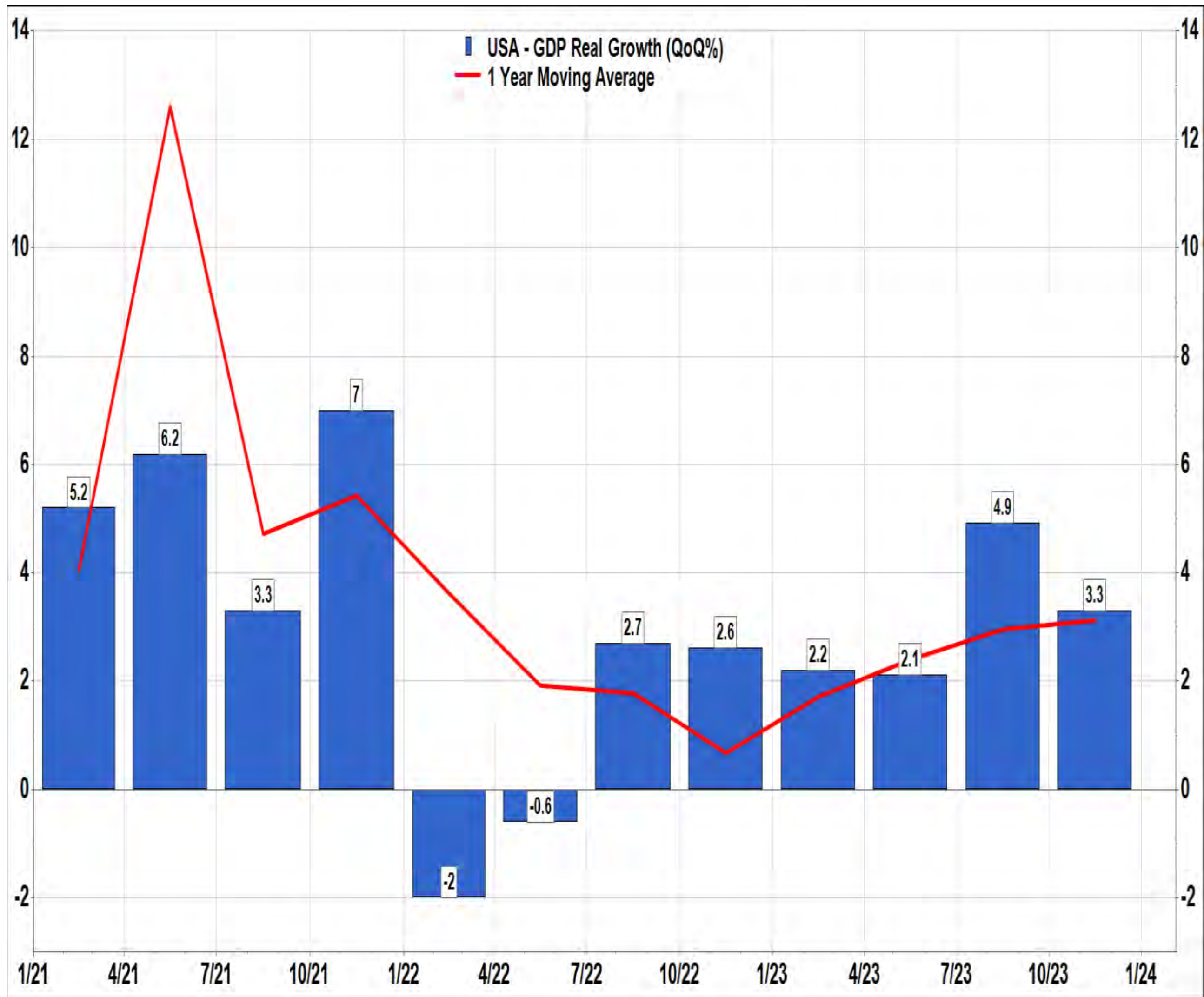
We detailed the measures the government enacted in 2020-21 on a previous page. The magnitude of the government's policy responses to the pandemic was obviously unprecedented, but very few would argue that they weren't necessary. And while the Infrastructure Bill and the CHIPS Act were enacted after much of the crisis had passed, there is general agreement that infrastructure is something that government is *supposed* to spend money on, and the CHIPS Act will provide a return that far exceeds its cost. In fact, manufacturing construction has doubled in the year after the law was enacted.

But the impact of such spending on the level of government debt and our annual fiscal deficits has been dramatic. Since the 1950s, government spending had reached a plateau of 16-20% of GDP, exceeding 20% only during the financial crisis of 2008-09. During COVID, spending rose above 30% of GDP, and is only now retreating back to the 20% level. Even allowing for the one-off nature of the COVID response, government spending has been growing faster than GDP for at least the last 15 years, to the point where the accumulated public debt now exceeds 125% of our GDP – and the gap is accelerating.

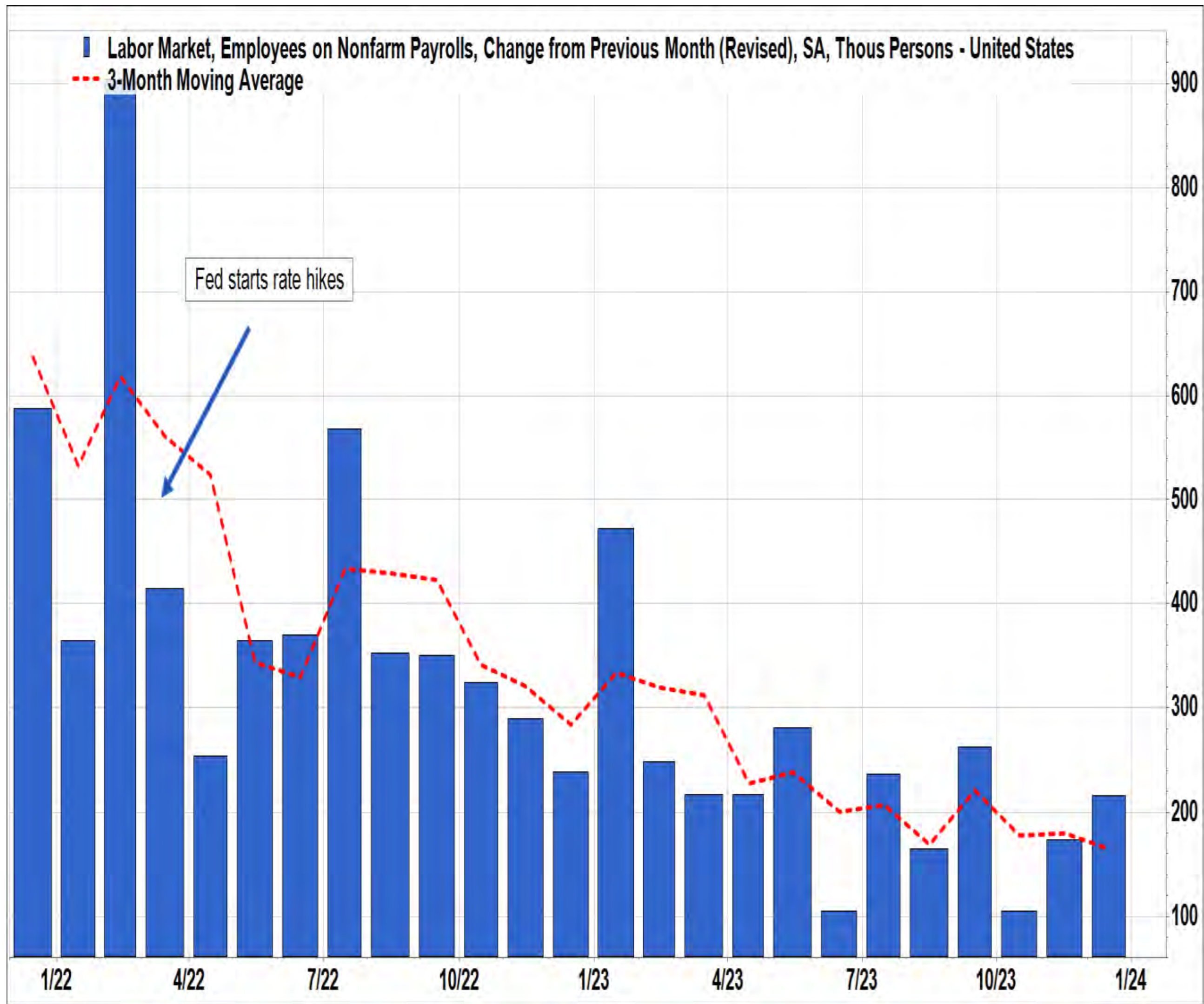



Of course, the level of debt is accelerating just as interest rates are rising, so the interest costs have risen from less than $500-billion three years ago to a projected $870-billion in fiscal 2024. Some would point out that since 70% of that debt is owned by American investors – pension funds, foundations, insurance companies and individuals – that represents a $60-billion inflow to the economy (more stimulus, anyone). But if left unaddressed and unchecked, the interest expense of our accumulated national debt is going to crowd out spending for critical national needs like national defense, infrastructure, education, health care and social security, with economic and social consequences that no one can foresee. Chances are the capital markets will react to the dangers long before our elected policy makers.

But all of that is for future discussion. For now, government stimulus measures have resulted in GDP growth that has consistently exceeded expectations. During the period in which the Federal Reserve raised short term interest rates no less than eleven times, the economy has grown for 6 consecutive quarters in real terms, and the rate of change in the last half of 2023 was greater than in the first half.



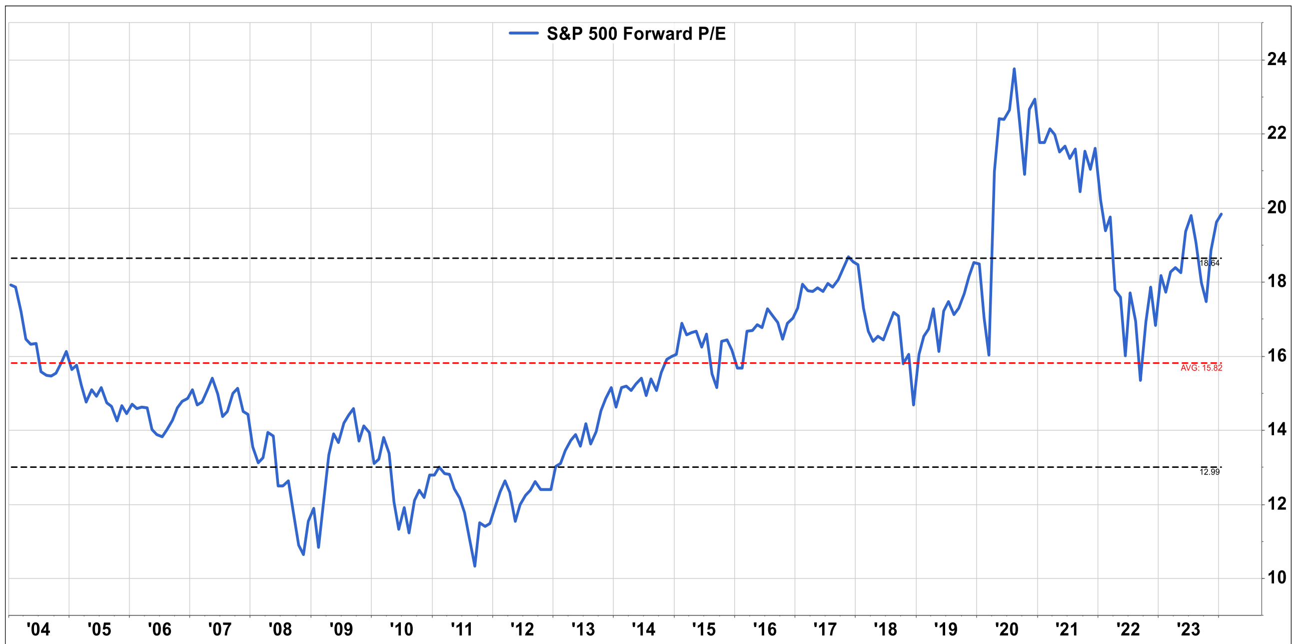

Meanwhile, the jobs market has cooled, but remains stronger than any analyst would have foreseen when the Fed rate hike cycle began almost two years ago. Job creation slowed in the second half of the year, but the November and December reports exceeded estimates and the 3-month moving average of new jobs has flattened out. Altogether, 2.7-million new jobs were added in 2023, and the unemployment rate has remained steady at between 3.4% and 3.7%. In fact, you have to go back more than 50 years – from December 1965 to January 1970 – to find a longer continuous stretch of unemployment below 4%!




So is it different this time, or just longer. At this point, it really doesn't matter – longer has gone on long enough that it's already different. While the Fed has its foot on the brake, Congress is pressing firmly on the accelerator. You would think that this isn't a responsible way to operate a vehicle, or an economy. But it has gotten us to where we are right now, which is a better place than we thought we'd be two years ago.

**Is the Improving Outlook Already Priced In to the Market**

If the consensus has shifted from recession to a soft landing or even no landing, the concern should then be whether the good news is already "priced in" by a market that was up more than 24% last year, and has risen another 5% in the first 7 weeks of 2024. The market's forward price/earnings multiple has risen to 20, more than one standard deviation above its 20-year average, and a level from which major upward moves rarely begin.




Investors and analysts commonly use the "market" and the "S&P 500" interchangeably, But any discussion of the market today, whether it be its performance, its valuation or its outlook, must contend with the fact that the S&P 500 is concentrated in a few mega-cap stocks to a greater degree than ever before. The Magnificent 7 stocks referred to earlier in this *Outlook* now account for more than 28% of the index, and their characteristics and valuations are becoming less reflective of the broader market.

The impact of the Magnificent 7 on the cap-weighted S&P 500 is such that the S&P rose 24% last year, but the Mag 7 big tech stocks were up a weighted average of almost 76%.  The Less-Than-Magnificent 493 rose just 12%.  The trend has continued into 2024 with the S&P 500 up 5% while the average stock is up just 1%.

## Equity market returns driven by Big Tech

Significant divergence between big tech and the rest of the market

The "Magnificent Seven" Stocks Drove S&P 500 Performance in 2023



| Magnificent Seven - S&P 500 Weights as of 12/31/2023 | | | | | | | |
|---|---|---|---|---|---|---|---|
| Apple | Microsoft | Alphabet | Amazon | NVIDIA | Meta | Tesla | **Total** |
| 7.0% | 7.0% | 3.8% | 3.5% | 3.1% | 2.0% | 1.7% | **28.0%** |

Note: Performance reflects price return not total return.
Source: Federated Hermes, Bloomberg as of December 31, 2023.

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The divergence of the Mag 7 in terms of valuations is equally notable. As a group, they trade at more than 30 times their forward 12-months earnings estimates, while the rest of the stocks in the index trade at an average multiple closer to 17 times forward earnings, barely above their long-term average. So, the "market" may not be as over-valued as the index multiple would suggest.

**But Do Valuations Matter?**

In the current market environment, valuations clearly do *not* matter. Hedge fund manager David Einhorn argued in a recent interview that due to the rapid rise of passive investing in index funds, the market is fundamentally broken as passive investors have no opinion about value.

The assets invested in passive (index) funds now exceeds the assets invested in actively managed funds, and so long as the market's rise remains concentrated in the out-performance of a handful of stocks which drive the index disproportionately, this phenomenon is likely to persist.

Value is no longer a consideration for *most* of the money invested in the equity market. The algorithms that drive passive investing are driven solely by price, not value, creating a vicious circle. As money moves from active to passive, undervalued stocks are sold off and the funds are put into the index where the most overvalued stocks have a disproportionate weight. In the current climate, stocks are not reverting toward value, they are diverging *from* value. It is an apathetic investment approach that assumes that the surest way to get your investment to rise is to start by buying things that are overvalued.

One must suppose that this is not a permanent condition. The market has a way of ridding itself of excesses and bubbles, and will surely do so in this case - eventually. As one of the senior members of our investment team reminded me recently, **valuations don't matter until they matter, and then they're the only thing that matters.** Perhaps the market's obsession with Artificial Intelligence (AI) will fade or be replaced by another obsession, or the bubble being created by the meteoric rise in the Magnificent 7 will burst in a 1987-style market event that sours investors on passive investing. But these are possibilities that will happen in time. For now, it is a dynamic that market participants must contend with.

## Speaking of 1987 …

Whether or not the market is over-valued on an historical basis, it is clearly coming close to being over-bought on a short-term basis. Most of the market's 30% rise over the last 14 months has come since the end of October, and the index is levitating well above its 200-day moving average. More concerning is the fact that the number of stocks participating in the market's rally actually broadened out during the November-December period, but it has begun to narrow again, and dramatically so.

On February 9th, when the NASDAQ rose and the S&P 500 broke the 5,000 barrier and rose to a new all-time high, there were twice as many stocks falling than rising. That hasn't happened since the day after Black Monday – 1987.

## Conclusions

At the moment, we seem to be in a better place economically than we feared we might be this time last year. The Fed may have indeed engineered the soft landing that most deemed unlikely when their rate hike cycle began belatedly in March 2022. While we – and the consensus – no longer have an imminent recession as our base case, it is worth noting that we are still "in the window" of when recessions have occurred in the past, following a yield curve inversion.

Inflation has fallen steadily toward the Fed's 2% target, although getting the rest of the way there could be bumpy. The troublesome inflation readings remain mostly in the service areas of the economy, which are less sensitive to interest rates than the manufacturing sector, and more sensitive to wage costs which continue to rise in this still healthy labor market.

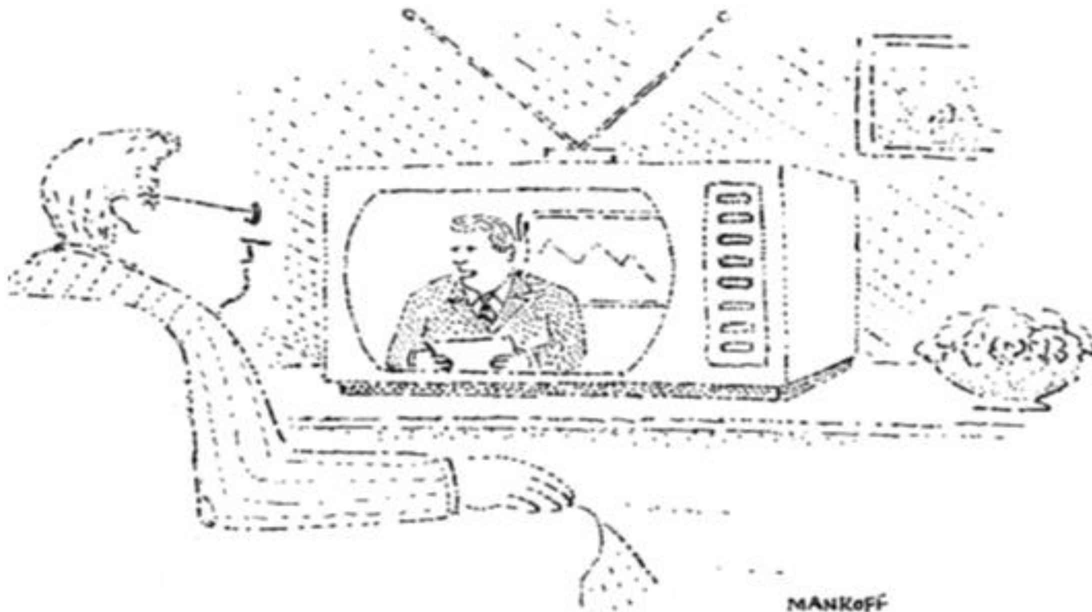
Coincident indicators of GDP growth and jobs show no signs of approaching recession-like levels, and leading indicators of future jobs growth, like initial unemployment claims, are holding firm.

The consumer, on the whole, appears to be in good shape, with jobs and wage growth steady and ample levels of savings to keep the economy growing. And as pointed out earlier, high real short term interest rates have resulted in record balances in money-market funds, which could find their way back into the real economy, or the markets.

We have previously mentioned two major concerns that pose a serious risk of major volatility in the equity market. The first is the rising level of government debt that we will probably not have the will to address unless the markets – both stock and bond markets – send a clear warning signal to our policymakers that this course is unsustainable. The second is the continuing rush into index funds, which is undermining the whole concept of value as a factor in allocating capital in the market. But these are longer term concerns and un-addressable at the moment.

As for the near-term outlook, our major concern is about what expectations are imbedded in the market at these levels. The market is a leading indicator of the economy, not a coincident one, and it may have moved too far ahead of the economy and the Fed during its recent rise.

The market rose sharply as the Fed signaled that it may have indeed reached the end of its series of rate hikes. Investors became giddy at the thought that the Fed might actually cut rates in 2024, starting as early as March. Some analysts forecast 3 rate cuts, still others said 6 cuts were possible. But enough of the Fed governors have expressed caution about cutting rates too soon, only to be forced to reverse course later if inflation persists above the Fed's 2% target rate. A number of responsible analysts have concurred.




*"On Wall Street today, news of lower interest rates sent the stock market up, but then the expectation that these rates would be inflationary sent the market down, until the realization that lower rates might stimulate the sluggish economy pushed the market up, before it ultimately went down on fears that an overheated economy would lead to a reimposition of higher interest rates."*

The Fed damaged its credibility in the early stages of inflation's rise post-COVID, insisting that it was "transitory" and would ease as supply chains were restored. Its credibility has been greatly restored since then, as inflation has eased and the economic slowdown and rising joblessness that was forecast has thus far been averted. We don't see the Fed risking damaging its credibility again by leaving the battlefield before the inflation fight is over. How the market reacts to that likelihood will largely determine how the markets perform in 2024.

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