PERFORMA

Q4 2023

# MARKET COMMENTARY

A QUARTERLY REVIEW OF THE MARKETS FEATURING MACRO AND GENERAL ASSET CLASS COMMENTARY

## MACROECONOMIC OVERVIEW

Almost four years after the initial COVID-19 outbreak and related lockdowns, supply and demand across the U.S. economy are coming back into balance. Indicators that defined the COVID era distortions have largely been unwound and a level of normalcy restored. Most important, inflation has trended meaningfully lower, which has allowed the Federal Reserve to take a patient, wait-and-see approach to monetary policy.

The consensus view heading into 2023 was that the U.S. economy would fall into recession. That recession never transpired and economic activity was healthy. The labor market proved to be particularly resilient. Job creation remains above long-term historical averages and initial jobless claims, which track people filing for unemployment benefits, are at historically low levels - giving no indication that we are about to see a dramatic weakening in labor market conditions. Steady job creation and now positive real wage gains are working to support consumption and broader economic activity. High frequency data that tracks air traffic as well as hotel and restaurant activity continue to paint a picture of an active U.S. consumer.

The noteworthy decline in inflation, coupled with a resilient labor market, have supported hopes that the U.S. economy will avoid the so-called “hard landing” where unemployment jumps and the economy falls into a painful recession. In fact, optimism was so high that the S&P 500 recently took another run at an all-time high of around 4800 during the fourth quarter as the Fed began prepping markets for lower rates in the year ahead (even though inflation is not yet back to target). While we are sympathetic to the fact that markets have become increasingly Fed dependent over the years and the Fed’s dovish pivot in December has only amplified increasingly bullish market expectations, we remain somewhat more cautious.

# ASSET CLASS OVERVIEW

**INVESTMENT GRADE BONDS:** While the door is still open for further rate hikes, the Federal Reserve has held the overnight borrowing rate steady since their July meeting when they raised rates for the 11th time to a 22-year high range of 5.25% to 5.50%. Market participants, however, are at odds with the Fed (whose dot plot indicates ~75 basis points [bps] of cuts by the end of 2024), whereas Fed Fund Futures are pricing in ~150 to 175 bps of cuts. Despite Fed language reaffirming their willingness to continue fighting inflation being virtually unchanged at their December meeting, traders sensed an all-clear signal, sending rates spiraling lower; the 2-year and 10-year U.S. Treasuries yields fell -80 bps and -69 bps to 4.25% and 3.88%, respectively, over the quarter. The Bloomberg U.S. Aggregate Index, a broad measure of the investment grade bond market, gained 6.82% during Q4 as rates rallied and option-adjusted spreads (OAS) on the Aggregate index tightened 10 (bps) to an OAS of 42 bps. Meanwhile, U.S. corporate credit spreads tightened -19 bps to an OAS of 93 bps. All sectors in the Aggregate index were positive over the period with utilities (9.69%) and industrials (9.03%) rising the most, while asset-backed securities (3.48%) and supranationals (3.85%) were up the least. On a ratings basis, lower rated credit outperformed with AAA's returning 4.72%, AA's 6.37%, A's 8.14% and BBB's 8.80%. The yield-to-worst (YTW) on the index fell 86 bps to 4.53% over the quarter, while the modified duration lengthened slightly to 6.24 years.

**HIGH YIELD BONDS:** During Q4, the ICE BofA U.S. Cash Pay High Yield Index gained 7.08%. The return was comprised of 5.36% in positive price performance driven by falling rates (yields down, prices up) coupled with spread tightening, while income/coupon produced an additional 1.72% of return during the period. Spreads tightened 64 bps to an OAS of 334 bps and the effective yield on the index fell -142 bps to 7.32% as both spreads tightened and rates fell. Meanwhile, the effective duration of the index shortened 1/3rd of a year to finish the quarter at 3.31 years. Of the major sectors within the index, banks (9.31%) gained the most, followed by retail (8.72%) and insurance bonds (8.34%). The transportation (3.82%), energy (5.16%) and technology & electronics (6.11%) sectors were up the least. On a ratings basis, BB's gained 7.37%, B's 6.81%, CCC's 6.85% and CC's 10.38%.

**U.S. EQUITIES:** The S&P 500 Index, widely regarded as the best gauge of large-cap U.S. equities, gained 11.69% during the final quarter of 2023. All sectors were higher over the period except for energy stocks (-6.93%), which were driven by a ~16% decline in WTI crude oil. Real estate stocks jumped 18.84%, led by gains in Simon Property Group (33.95%) and American Tower Corp (33.66%). Tech stocks gained 17.17%, led by Advanced Micro Devices (43.37%) and Intel Corp (41.82%) on solid Q3 earnings, combined with AI hype. Year-to-date, the index is up 26.29% with the top 7 names being responsible for 60% of the return (MSFT, AAPL, NVDA, AMZN, META, TSLA, GOOG).

Mid-cap stocks, as represented by the Vanguard Mid-Cap ETF, outperformed their larger cap peers by 0.58% during Q4 after gaining 12.27%. Consumer discretionary (17.52%) stocks gained the most, led by Expedia Group (47.27%) after the company beat Q3 profit estimates and announced a $5 billion share buyback program. The interest rate sensitive real estate sector was close behind, trading higher by 16.47% as rates fell and the odds of cuts in 2024 increased. Like their larger cap peers, the energy sector (-1.65%) traded off the most in sympathy with oil. Consumer staple stocks were up the least (6.46%), with Hormel Foods and McCormick providing the most headwinds to further gains for the sector.

Small-cap stocks, as represented by the Vanguard Small Cap ETF, outperformed their larger cap peers, returning 13.40%, with the value component returning 13.62% while the growth component gained 13.12%. All sectors were higher over the quarter except for the energy sector that lost -5.80%. Consumer staples (6.79%) was the only other sector that didn't produce double digit returns for the period, held back by food, beverage & tobacco stocks such as Boston Beer (-11.28%) and Beyond Meat (-7.48%). Financial stocks were up the most (17.94%) with the banking component higher by 26.22%, financial services up 18.06% and insurance stocks gaining 6.00%. Consumer discretionary stocks weren't far behind financials (17.02%), led by retailer Gap Inc, which shot up 99.59% after adjusted EPS beat estimates by $0.40.

**INTERNATIONAL EQUITIES:** The iShares EAFE ETF, which tracks the MSCI EAFE Index and covers developed countries in Europe, Australasia, Israel and the Far East, gained 10.81% and largely kept pace with U.S. stocks in a period where the U.S. dollar lost -4.56% against a basket of major world currencies. All sectors were positive in Q4; technology stocks were up the most (21.32%), driven by contributions from chip maker ASML Holdings, which gained 27.59%, and enterprise resource planning software co., SAP SE, which ascended 18.54%. Following tech, the materials and real estate sectors returned 17.22% and 14.97%, respectively. Energy, health care and consumer staples were the worst performing sectors but still managed returns of 0.40%, 4.90% and 5.22%, respectively.