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Market Review and Outlook

4Q23

Highlights

Equity markets moved appreciably higher in 2023, with the S&P 500 Index posting a 26% gain and closing the year just below an all-time high.

The S&P 500's outsized returns during 2023 were disproportionately attributed to the index's concentrated exposure to seven high-flying technology-related stocks (the "Magnificent 7").

A potential rotation out of richly valued Magnificent 7 stocks and into more attractively priced sectors/companies left behind in the rally creates a compelling case for diversified/active investment management strategies in 2024.

While the economic backdrop has remained surprisingly supportive thus far, the consensus forecast of double-digit S&P 500 earnings growth for 2024 seems overly optimistic.

The U.S. Aggregate Bond Index posted a +6% total return in 2023, an encouraging development after a rare two-year stretch of negative bond returns from 2021-2022.

With the increase in bond yields over the last couple of years, bonds now offer attractive starting yields that are more competitive with the return outlook for equities.

Market Review and Outlook

Global equities posted solid gains in 2023, mounting an impressive rebound from the double-digit declines reported during 2022. Domestic equities demonstrated particular strength, with the S&P 500 notching a 26.3% total return for the year. The path to those gains, however, was hardly smooth. The index climbed to a (then) cycle high in late July, but a 10%-plus correction ensued thereafter through late October as rising interest rates weighed on investor sentiment. As U.S. Treasury rates moved back down, the market rallied more than 15% to close the year near an all-time high. International stocks followed a similarly bumpy route over the year, but also ended 2023 with strongly positive returns. The developed markets (EAFE) reported a total return of 18.2% during the year and emerging markets (EM) posted an annual gain of 9.8%.

The predominant factors contributing to the outsized U.S. equity returns during 2023 included: moderating inflation pressures, a recession-resistant economy that has grown at an above-average pace, and enthusiasm around artificial intelligence (AI). The overarching beneficiaries of those market tailwinds were the largest seven technology-related stocks (Apple, Microsoft, Amazon, Nvidia, Alphabet, Meta, and Tesla) widely termed the “Magnificent 7”, which collectively generated a median gain of more than 80% for the year. Because these companies now represent nearly 30% of the capitalization-weighted S&P 500 Index (the highest-ever share for any seven stocks), they accounted for about two-thirds of the S&P 500’s total return for the year. Without the Magnificent 7, the S&P 500’s median stock gain was a more modest 9%. In fact, 35% of stocks in the index still posted negative returns during 2023.

There are sound justifications as to why investors flocked towards the Magnificent 7 stocks during the past year. In addition to the longer-term AI secular growth story, their quality balance sheets (with large cash balances) and good cash flow profiles were seen as compelling attributes in a highly uncertain economic environment. That said, the implication that there are only seven quality growth opportunities throughout the equity market is misguided. Crowding into a thin and shrinking subset of stocks is consistent with past late-cycle market behavior, but it’s not a prudent investment strategy. As demonstrated in the table below, sector (and asset class) leaders/laggards tend to continuously rotate as the market cycles.

S&P 500 Sector Return Quilt

(12/31/13 - 12/31/23)

2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Cons.Disc 43.1%	Real Estate 30.2%	Cons.Disc 10.1%	Energy 27.4%	Technology 50.3%	Health Care 6.5%	Technology 50.3%	Technology 43.9%	Energy 54.6%	Energy 65.7%	Technology 56.3%
Health Care 41.5%	Utilities 29.0%	Health Care 6.9%	Comm.Serv 23.5%	Materials 23.8%	Utilities 4.1%	Comm.Serv 32.7%	Cons.Disc 33.3%	Real Estate 46.2%	Utilities 1.0%	Comm.Serv 53.2%
Industrials 40.7%	Health Care 25.3%	Cons.Stpls 6.6%	Financials 22.8%	Cons.Disc 23.0%	Cons.Disc 0.8%	Financials 32.1%	Comm.Serv 23.6%	Financials 35.0%	Cons.Stpls -0.6%	Cons.Disc 39.9%
Financials 35.6%	Technology 20.1%	Technology 5.9%	Industrials 18.9%	Financials 22.2%	Technology -0.3%	S&P 500 31.5%	Materials 20.7%	Technology 34.5%	Health Care -2.0%	S&P 500 26.3%
S&P 500 32.4%	Cons.Stpls 16.0%	Real Estate 4.7%	Materials 16.7%	Health Care 22.1%	Real Estate -2.2%	Industrials 29.4%	S&P 500 18.4%	S&P 500 28.7%	Industrials -5.5%	Industrials 18.2%
Technology 28.4%	Financials 15.2%	Comm.Serv 3.4%	Utilities 16.3%	S&P 500 21.8%	S&P 500 -4.4%	Real Estate 29.0%	Health Care 13.4%	Materials 27.3%	Financials -10.6%	Financials 12.8%
Cons.Stpls 26.1%	S&P 500 13.7%	S&P 500 1.4%	Technology 13.8%	Industrials 21.0%	Cons.Stpls -8.4%	Cons.Disc 27.9%	Industrials 11.1%	Health Care 26.1%	Materials -12.3%	Materials 12.6%
Materials 25.6%	Industrials 9.8%	Financials -1.5%	S&P 500 12.0%	Cons.Stpls 13.5%	Comm.Serv -12.5%	Cons.Stpls 27.6%	Cons.Stpls 10.7%	Cons.Disc 24.4%	S&P 500 -18.1%	Real Estate 12.4%
Energy 25.1%	Cons.Disc 9.7%	Industrials -2.5%	Cons.Disc 6.0%	Utilities 12.1%	Financials -13.3%	Utilities 26.3%	Utilities 0.5%	Comm.Serv 21.6%	Real Estate -26.1%	Health Care 2.1%
Utilities 13.2%	Materials 6.9%	Utilities -4.8%	Cons.Stpls 5.4%	Real Estate 10.8%	Industrials -13.0%	Materials 24.6%	Financials -1.7%	Industrials 21.1%	Technology -28.2%	Energy -0.6%
Comm.Serv 11.5%	Comm.Serv 3.0%	Materials -8.4%	Real Estate 3.4%	Energy -1.0%	Materials -14.7%	Health Care 20.8%	Real Estate -2.2%	Cons.Stpls 18.6%	Cons.Disc -37.0%	Cons.Stpls -0.8%
Real Estate 1.6%	Energy -7.8%	Energy -21.1%	Health Care -2.7%	Comm.Serv -1.3%	Energy -18.1%	Energy 11.8%	Energy -33.7%	Utilities 17.7%	Comm.Serv -39.9%	Utilities -7.1%

Source: FactSet

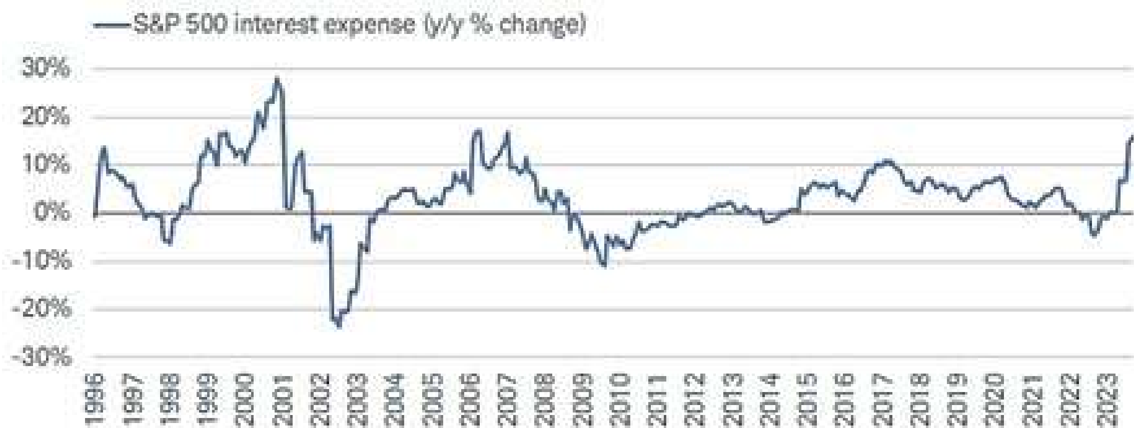
With the Magnificent 7 stocks (comprised of the largest consumer discretionary, communication services, and technology companies) trading at a median P/E of 29x, more than 60% above the 18x median P/E multiple of the remaining 493 S&P 500 Index constituents, one of two developments is likely to occur from here. If the economy remains supportive, a rotation out of richly valued Magnificent 7 stocks and into more attractively priced sectors/companies left behind in the rally is possible. Alternatively, if economic conditions deteriorate, the mega-cap highfliers could be susceptible to a more pronounced correction than the rest of the market—similar to what occurred in 2022 (when the Magnificent 7 stocks declined 40% versus a more modest 12% drop for the remaining stocks in the S&P 500). All of this creates a compelling case for diversified/active investment management strategies in 2024.

Investors have seemingly become much less concerned about the prospect of a looming U.S. recession than they were 12-18 months ago, but an economic downturn in 2024 is still a distinct possibility with the typical harbingers of recession (e.g., an inverted yield curve and a sustained decline in leading economic indicators, or the LEI) still flashing caution. While the economy grew at a surprisingly rapid 4.9% pace during the third quarter of 2023, that was an aberration and likely borrowed growth from future quarters. GDP tracking estimates suggest growth slowed to just 1% in the fourth quarter and consensus forecasts for the first and second quarters of 2024 currently reflect minimal GDP growth.

It's conceivable GDP could even turn negative this year if consumer and/or business spending slows, as the impact of a 5.25% spike in the Fed funds rate over a relatively truncated period is more fully absorbed by the economy. While Treasury yields have receded from their October 2023 peaks, rates are still well above levels borrowers became accustomed to in recent years. Higher borrowing costs on mortgages (for new homebuyers), auto loans, and credit cards are likely to result in more cautious spending on other items by consumers, who drive about 70% of economic growth. Meanwhile, businesses have seen their interest-bearing expenses surge by a rate not seen since prior to both the 2000-01 and 2007-08 recessions, which could create a drag on corporate spending and profit expansion in 2024.

Change in corporate interest expense is surging

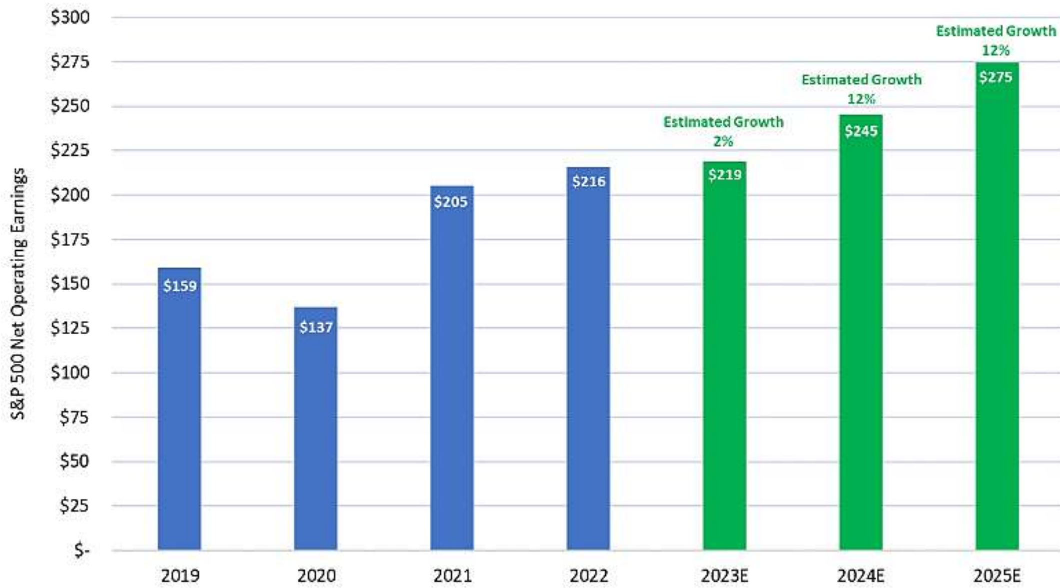
(12/31/95 – 9/30/23)



Source: Charles Schwab, Strategas Research Partners

Against those economic headwinds, the consensus forecast of a double-digit percentage (+12%) S&P 500 earnings growth estimate for 2024 (and 2025) seems overly optimistic.

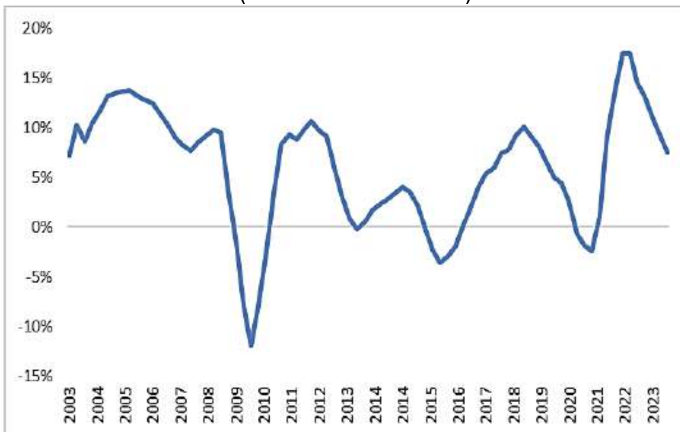
S&P 500 Earnings History and Estimates
(12/31/19 – 12/31/23)



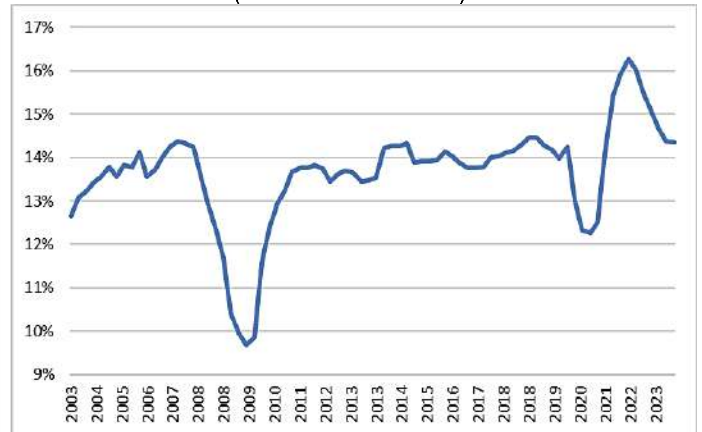
Source: FactSet

Profits could certainly move higher this year and next, but with less of a revenue tailwind from inflation (i.e., a less favorable pricing environment) and corporate operating margins having already receded from the cyclical peaks reached during bumper consumer demand, earnings growth in the coming year may prove more subdued than the current double-digit growth forecasts.

S&P 500 Quarterly Sales Growth (ttm)
(12/31/03 – 9/30/23)



S&P 500 Quarterly Operating Margin (ttm)
(12/31/03 – 9/30/23)



Source: FactSet

As noted above, equity valuation metrics currently span the spectrum of cheap/moderate/rich, depending on the individual sector or asset class. The S&P 500 Index in aggregate, however, is trading at a P/E multiple of 19.5x, which is roughly 20% above the historical average. This suggests valuation multiple expansion for the index may be limited from here, leaving earnings growth as the principal driver of market returns over the near to medium term. If earnings fail to meet the lofty consensus estimate laid out for 2024 (which implies a return to peak margins), stocks could disappoint relative to Wall Street forecasters' increasingly bullish expectations. And with the prospect for a more normalized (i.e., higher) interest rate backdrop than experienced over much of the last 15-year period following the 2008 Great Financial Crisis,

investors will also need to recalibrate their longer-term expectations relative to the returns they enjoyed over the last decade and a half.

New twists and turns in the market backdrop are certain to emerge in 2024. While the unexpectedly strong rally in equities last year may have borrowed from the return potential this year, there are still catalysts that could push the market higher moving forward. Inflation continues to moderate and the Fed is already paving the road for three rate cuts this year, suggesting (but not ensuring) that this cycle's peak interest rate is in the rearview mirror. And with valuations outside of last year's mega-tech gainers remaining reasonable, thoughtful stock selection among the lagging companies/sectors could produce healthy investment returns—even if market performance overall disappoints. Thus, there are plenty of reasons to remain cautiously optimistic and to stay invested throughout the market's inevitable cyclical swings in the year ahead.

Core Portfolio

The fourth quarter was a quiet one in terms of transaction activity within the core portfolio. While we continue to actively scour the equity universe for new investment ideas, we did not initiate any new positions. Similarly, we did not exit any prior core holdings in the quarter, as we believe our current portfolio mix appropriately balances upside potential with near-term capital preservation.

Tactical Portfolio

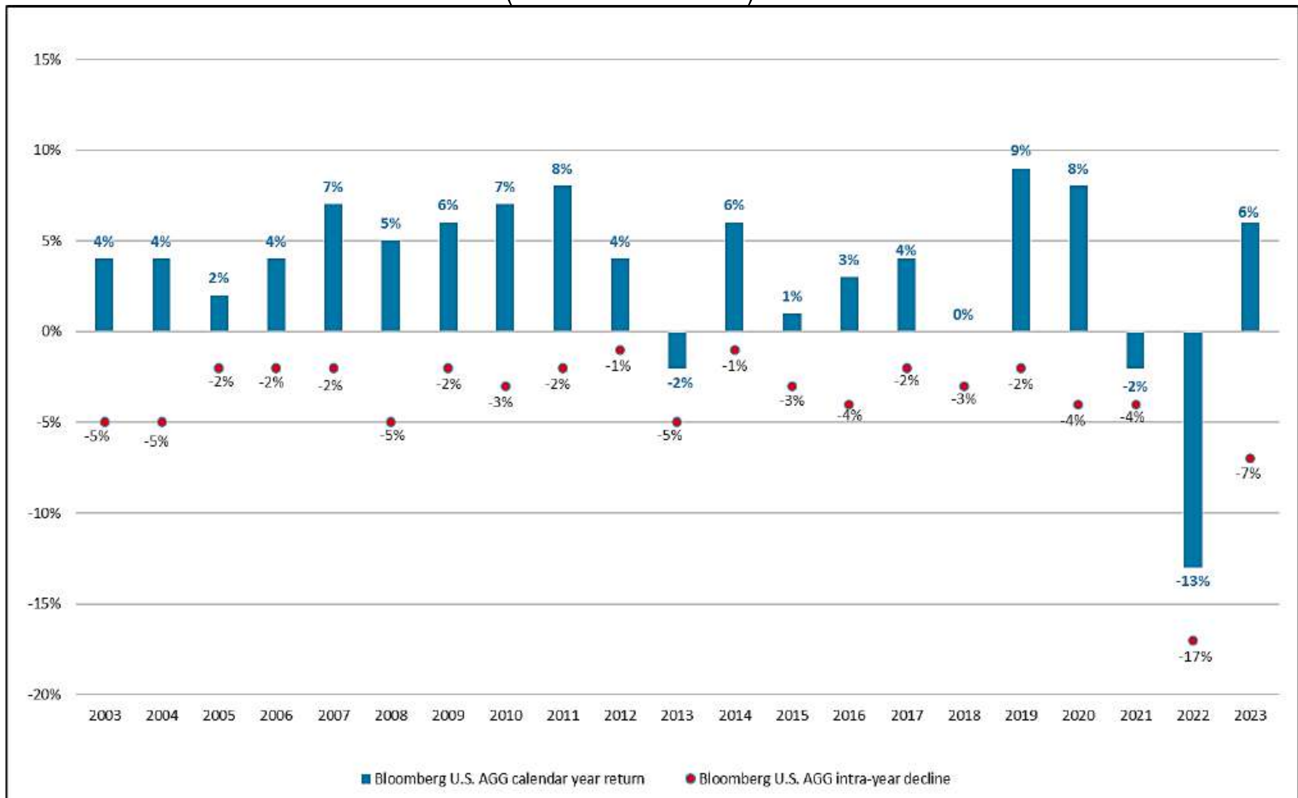
In the tactical portfolio, we invested in the iShares Mortgage-Backed Securities ETF (MBB), which is composed of mortgage-backed pass-through securities issued/guaranteed by U.S. government-backed agencies (such as Ginnie Mae, Fannie Mae, and Freddie Mac). With the average 30-year mortgage rate soaring to 8.0% in October (the highest since 2000) and hovering at a wider-than-normal gap to the 10-year Treasury yield (3.0% spread vs. 1.7% historical average spread), we viewed agency mortgage bonds as a compelling investment opportunity given their robust credit quality, high coupon yields, and capital appreciation potential as interest rates decline and/or spreads compress.

We also added exposure to the beaten-down regional banking sector by initiating a position in the SPDR S&P Regional Banking ETF (KRE), which holds a diversified stake in 140 small- and mid-sized banks. Regional banks were ground zero during the spring-2023 banking crisis, as a price decline in banks' Treasury holdings (from increasing interest rates) and declining commercial property values put particular stress on small and mid-sized banking balance sheets. This caused the unexpectedly rapid collapse of three prominent (albeit over levered) regional banks and spurred contagion concerns across the rest of the industry. Government intervention helped to prevent further bank failures in the near term, while subsequent improvement in economic conditions and declining interest rates buoyed the sector's medium-term prospects. Regional bank valuations still reflect overly pessimistic sentiment, however, creating a compelling risk/reward opportunity to invest in the space.

Fixed Income

The 10-year Treasury yield fluctuated between a wide band during 2023—ranging from as low as 3.25% in April amid the wake of the banking crisis, to as high as 5.02% in October on surprisingly strong third-quarter economic growth, before ending the year back at a yield of 3.88% (unchanged vs. 3.88% at the end of 2022). Despite the erratic round-trip in rates, fixed income performance moved back into positive territory for the year with the aggregate bond index posting a +6% total return—an encouraging development after an unprecedently rough two-year stretch for bond returns from 2021-2022.

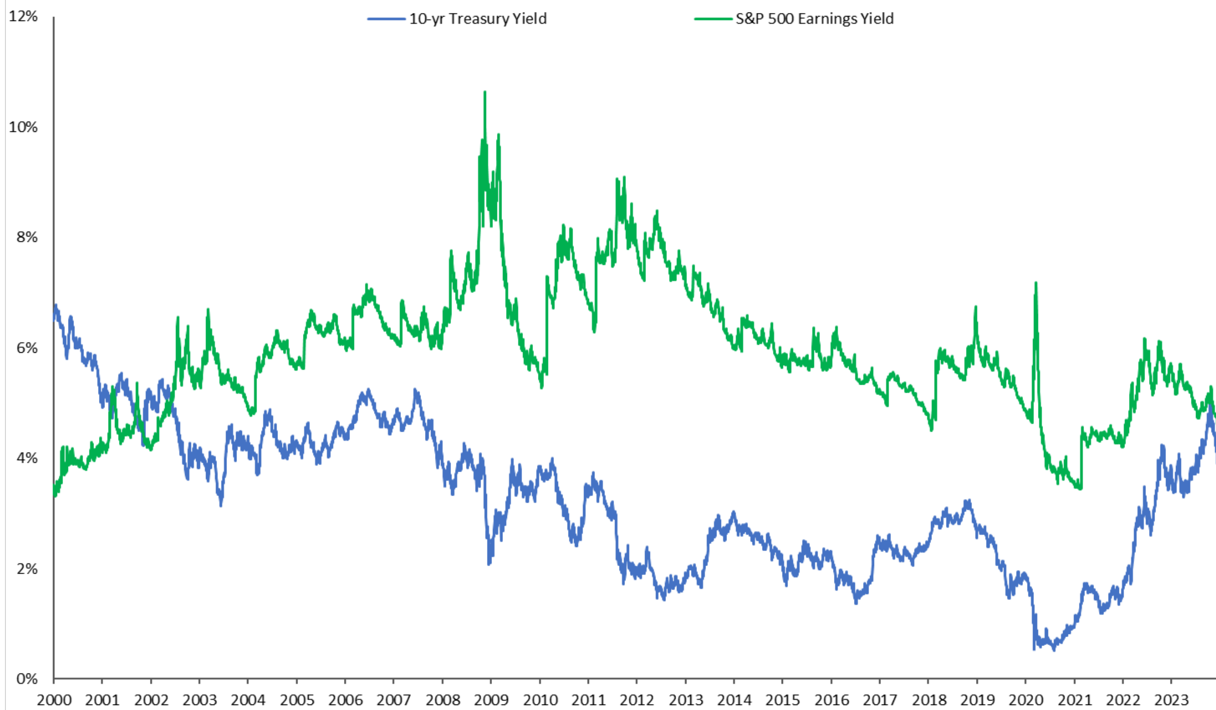
Bloomberg U.S. Aggregate Bond Index Returns
(12/31/03 – 12/31/23)



Source: Bloomberg, FactSet, J.P Morgan Asset Management
Returns based on total return. Intra-year drop refers to largest market drop from a peak to trough during the year.

With the increase in bond yields over the last couple of years, bonds now offer attractive starting yields that are more competitive with the return outlook for equities. To evaluate the return prospects of stocks and bonds, investors often compare the 10-year Treasury yield to the S&P 500's earnings yield (the inverse of the index's price-to-earnings ratio), which provides a rough approximation of stocks' long-term expected price return. For the last two decades, the S&P 500's earnings yield has exceeded the Treasury yield by a healthy margin (3.0% on average), meaning stock investors could expect materially more price return (not counting dividend returns) than bond investors would receive in interest income. That gap is much smaller today (0.7%), however, suggesting that prevailing bond yields are much more competitive with potential equity price returns.

10-Year Treasury Yield vs. S&P 500 Earnings Yield
(12/31/99 – 12/31/23)



Source: FactSet

In 2024, Treasury yields appear poised to move lower (pushing prices higher)—assuming the Fed cuts interest rates multiple times during the year as expected. That could provide an additional lift to fixed income returns in the coming quarters, though bouts of volatility should be expected along the way as markets continue to try to anticipate the timing and magnitude of Fed policy moves. Temporary fluctuations aside, the risk/reward outlook for fixed income markets remains attractive.

Final Thoughts

We would like to extend our warmest wishes to you and express our sincere appreciation for the continued trust you place in us.

While we were pleased by the sustained market recovery in 2023, we were shaken by the disturbing geopolitical tragedies and subsequent social divide that ensued during the year. We hope the world becomes a more peaceful place in 2024.

All the best in the new year!

Parkside Investments, LLC

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