HILLTOPBANK
Wealth Management

QUARTERLY MARKET INSIGHTS – FOURTH QUARTER 2023

To the Clients and Friends of Hilltop Bank Wealth Management:

There is no shortage of metaphors to describe how the changing of the year makes folks feel – a blank canvas, an empty slate, a turning of the page. On that note, it occurs to me that it has likely been some time since many of us have physically turned the page on the new year, whether it's ripping the last page off a wall calendar or finally completing that daily planner that will now spend the rest of its life in a desk drawer.

Instead, most of our schedules are now dictated to us by our phones or email, and they don't stop with our schedules. We are constantly inundated with news and new information, and more often than not it is framed in whatever manner will keep us engaged. Typically, that means it's intended to either enrage us or cause despair. This also seems to be having a particular impact on how we Americans viewed the economy in 2023.

For most of the time we have been tracking such things, consumer confidence in the US has closely followed economic indicators. In fact, in most of the world that is still the case. Since the pandemic, however, surveys of US consumers have reported that Americans are just as negative on the economy as they were in 2008-09. A very different time.

Interestingly, other surveys tend to show that while three-quarters of us would say that our personal finances are in good shape, only about one-quarter of us think the average American's are better than "fairly bad". If so many Americans are doing well individually, why don't we as a nation believe that we are in aggregate?

Certainly, the first bout of inflation in a generation has a lot to say about why Americans are feeling so pessimistic. While it may surprise you to find out that average wages have grown faster than inflation, even those who saw their incomes increase do not enjoy spending more for the same amount of utility.

Another factor I tend to credit with impacting our outlook is the framing of our news. The ubiquity of its access to our attention makes us particularly susceptible to the way in which that news is presented, and those who track such things have shown that for a while now that framing has been increasingly negative. The result is that, as a group, we have become uniquely low-spirited. Unfortunately, with an election year upon us, that is unlikely to change in 2024.

Are we justified in feeling so gloomy? In time, that pessimism may seem prescient, but for the year 2023 we do seem to have benefitted from a good deal of luck.

2023 Recap

Despite the tenor of news coverage, 2023 was not nearly as bad as many, myself included, expected.

While the markets began the year solidly, they spent most of the summer on vacation. Like someone racing to complete their New Year's resolution, they rallied strongly in the final two months to produce one of the better annual outcomes you tend to see.

After six consecutive months of losses in the bond market (the first time in history that's happened), the Bloomberg U.S. Aggregate Bond Index rallied 8.5% over the last two months (the seventh-best two-month return since 1926). Bonds rose 5.5% for the year in total, which is half a percent better than their average.

On the equity side, the S&P 500 ended the year up 26.3%. That's one of thirty-seven years since 1926 that equity returns have been higher than 20%. Interestingly, while equities average 10.3% return annually, they rarely hit that mark in any given year. In only six instances since 1926 have equity returns been between 8% and 12%.

The impetus for that rally was twofold. First, The Fed has now signaled to the market that they believe they are done hiking interest rates for this economic cycle. While inflation remains above their two percent goal, they feel they have seen enough to believe it will continue to come down. Second, the economy showed greater resilience in 2023 than expected. Gross Domestic Product is expected to have grown about 3.3% for the year, and the unemployment rate has stayed relatively steady at the low level of 3.7%. What is more, inflation has fallen to about 3.0% depending on how you measure it. This has many declaring that a soft landing has been achieved for just the second time ever.

How did this happen? The simplest telling of the story is through aggregate supply and demand, which we've talked about before, and it goes like this:

In 2020-21, the government printed a lot of money, spent a lot of money, and borrowed a lot of money. That pumped up aggregate demand and inflation went up. In 2021-22 supply chains got stressed, and oil prices rose. Those decreased aggregate supply and inflation went up again. In this letter last year, we discussed the possibility of a recession being a probable, if not necessary, condition for returning inflation to normal.

By the end of last year, however, the shocks to aggregate demand from fiscal policy, and to aggregate supply from the pandemic, appear to have retreated at remarkably similar paces and magnitudes. We have made progress on the inflation front as a result, GDP has remained positive, and unemployment has remained low. So far, we have threaded the needle and avoided that recession.

Looking Ahead

At some point this year it is likely that the Fed will cut rates. In the past, we have said this would occur either if something breaks, or inflation is back on track to two percent. While both those prerequisites still apply, it is now more likely to be the latter than the former. That is primarily due to the progress made toward that inflation goal.

Moving into 2024 will be another chapter in the same story. Projections for GDP growth are low, around one percent from most forecasters. That is both the result and the goal of tighter monetary policy. Whereas the economy benefitted greatly from the strength of US consumers in 2023, higher interest rates and the accumulated inflation of the past few years will have an impact on their continued purchasing power. Thus, if we are to complete the soft landing, we will have decreasing room for error.

In the markets, bonds are well-positioned to benefit from both price appreciation and higher coupon payments. On the equity side of things, we have seen valuations move up again after retreating from very high levels early in the pandemic. Valuations outside of the US are more favorable, but this is at least somewhat due to the fact that those cash flows are less predictable. Looking back in a few years, I suspect commentators will tell us that Europe is already in a recession, in addition to past discussions in this letter about the headwinds facing China.

On the positive side, higher interest rates have pulled a great deal of capital into money market funds and ETFs. While much of this will move back toward bank accounts rather than investment, it could also provide a tailwind for fixed income and equities should those investors come to value the higher yields on offer in the markets. A higher interest rate regime also presents the possibility of normalizing valuations across equities, meaning companies with future cash flows closer at hand may benefit. In the parlance of finance, that means value stocks.

Finally, as our never-ending news cycle turns over to politics, you will hear a great deal about what one side or the other has done or will do for markets. When you do, I encourage you to not just be mindful of who is presenting the data, but also of the data itself. The truth is, in the last hundred years we have only had twenty-four presidential elections so far. From a statistical standpoint that is an insufficient sample size to determine much of anything, let alone a reason to change investment strategies.

For comparison from another venue in which you can find yourself inundated by too much information, the average Major League baseball team sent players up to bat a total of 6,137 times last season. That works out to about thirty-eight at bats per team, per game. If you based your expectations on the first twenty-four of those plate appearances, you would be predicting the outcome of the season before you even finished the sixth inning of the first game. Further, I would contend that there is a far greater variety of factors and outcomes for the 4,000+ publicly listed companies in our country than even the 1,457 major leaguers who stepped up to the plate.

In conclusion, as we do turn the page on the new year, I hope you're able to find some peace from the news, that we are able to complete a soft landing, and that we all get a few good pitches to hit.

Best,

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