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BALLENTINE PARTNERS

Market Update

2023 Market Review: Asset Prices Climbed the Wall of Worry

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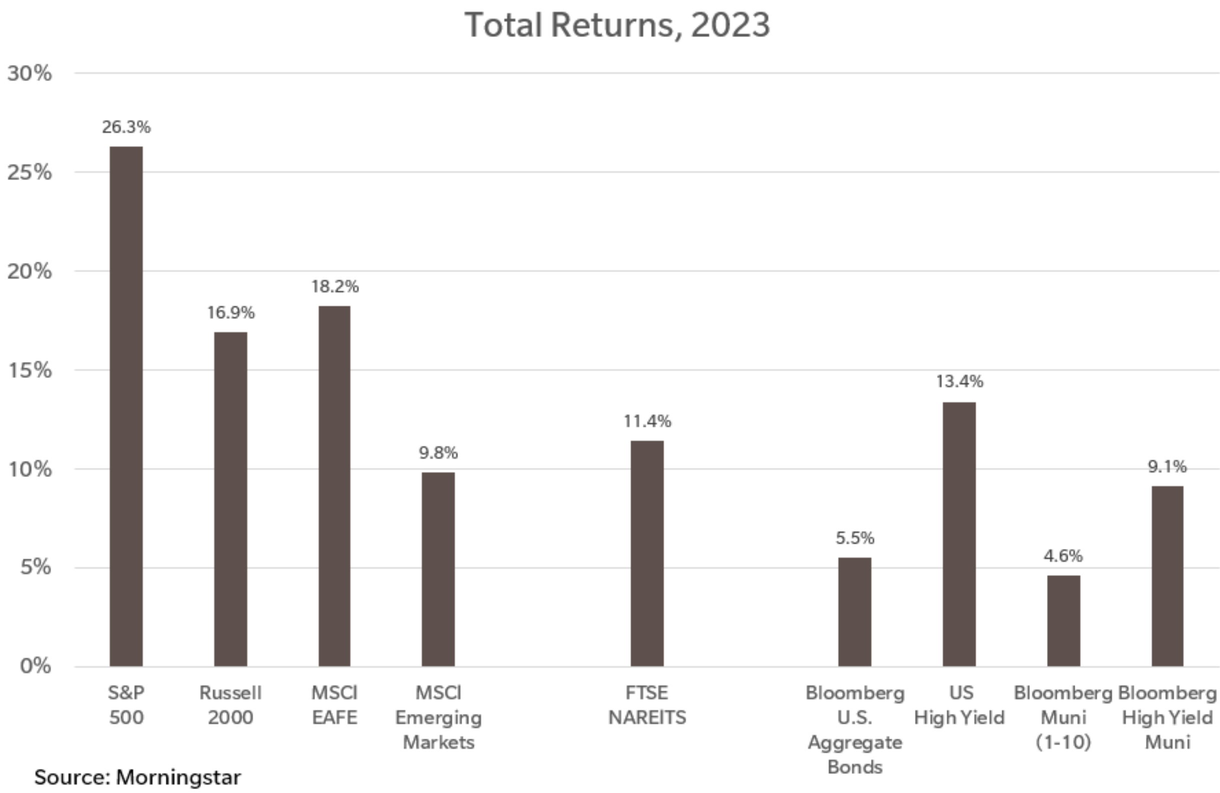
Market Recap

At the beginning of 2023 (and a few months in), the mood in the markets was downright dour. 2022 had not been kind – with both equities and bonds suffering some of their worst returns in over a decade – and the conventional view of the future was equally bleak. The laundry list of worries included the following:

1. **A deeply inverted yield curve**. Nearly every economic forecasting model ever built includes the dreaded inverted yield curve as a reliable predictor of recessions. And 2022 started the year inverted, only to become even more inverted, the most in over four decades. Ominous.
2. **Leading Economic Indicators were pointing to a recession.** The LEI, which has been around for decades as a trusted crystal ball of economic activity, was pointing toward a recession.
3. **The poor track record of prior Feds.** The rapid rise of the Fed Funds rate during all of 2022, the fastest in over 40 years, was certainly cause for worry. While every Fed in the past has tried to tame inflation without triggering a nasty recession, the track record of prior Feds is abysmal, so the odds of this Fed pulling off a soft landing were certainly suspect.
4. **Wall Street experts.** Towards the end of 2022, the official Bloomberg Economics model showed a 100% probability of recession in 2023. They were not alone in their pessimism, as a survey of major Wall Street banks put the odds of a recession at over 70%.
5. **The consumer pinched by rising rates.** The conventional view was that rising rates would cool consumers' appetites for goods and services. So much of the economy and consumer purchases are done on credit, so the rapid and painful rise in borrowing rates would dampen consumption.
6. **Three of the worst bank failures in U.S. history.** Soon after the start of 2023, the U.S. suffered three of its worst bank failures ever. The fear was that the panic could spread and further tighten bank credit.

Yet the market climbed this proverbial "wall of worry" with gusto, completely contrary to the conventional views above. Essentially all risk assets delivered double-digit returns. The S&P 500 rose over 26%, while international markets also delivered in the high teens. Bonds also delivered solid returns despite the continued rise in rates at both the long and short end of the curves. See chart on the next page.



Source: Morningstar

So, what went on here? First, the U.S. economy showed surprising resilience. As it turned out, the consumer was in much better shape than many had anticipated. Strong labor markets and rising real wages led to a willingness to spend. TSA throughput at U.S. airports zoomed past pre-pandemic levels. And retail sales surged. Second, while rising interest rates certainly were crimping spending in some households, it turned out that most household's significant interest expense – their mortgage – was largely insulated from the hike in rates; most had financed or re-financed their mortgages in the prior decade, locking in historically low rates. Third, the Fed stepped in to provide liquidity and backstopping during the bank failures in March, stemming the panic. Fourth, earnings growth and profit margins proved equally resilient, as supply chain issues were essentially resolved, and companies were able to continue to pass any additional input costs along to the healthy consumer. Fifth, excitement over Artificial Intelligence and its promises of efficiency and money-making possibilities drove a large chunk of the 2023 rally. (Nvidia was up 235% and increased its market value by nearly $1 trillion – with a "t" – in 14 months). And finally, inflation numbers came down materially. CPI peaked at 9.1% in the summer of 2022 but declined to 3.1% by November's 2023 reading. The conventional view that the Fed would inevitably fail at navigating a soft landing shifted to a much more optimistic view.

Outlook and Strategy

We remain constructive on the U.S. economy.

The healthy cooling effects of higher interest rates have created a steady, albeit non-linear, path of encouraging inflation numbers. Inflation numbers are being kept aloft by mostly sticky prices like housing costs, which should come down; the Fed is not at their 2% target rate, but we know these interest rates take time to work their way through the system, and the Fed was still hiking rates only five months ago. We remain constructive on the U.S. consumer, the backbone of the U.S. economy. Their wages continue rising, and jobs appear plentiful (yes, of course, some sectors of the economy are stronger than others, but that is always the case). They are "feeling" wealthier. If they owned a home, it has risen in value steadily. If they owned stocks or bonds, they are feeling the very positive effects of the equity bull market of 2023 and higher interest rate payments from their money markets, bank CDs, and bonds (as opposed to a 15-year interest rate drought).

However, we also remain vigilant on many outstanding risks.

First, this shift from pessimism to optimism has a dark side: complacency and high valuation. Large-cap growth stocks, in particular, give us pause. The rally in growth (the Russell 1000 Growth index was up 43%) was good, perhaps too good, as they are looking the most expensive they've been in over two decades. There are many reasons to think that AI enthusiasm has gotten ahead of itself. It certainly would not be the first time that a new technology is driven to silly, if not dangerous, valuations (Nvidia's price/sales ratio jumped to 35x by mid-2023, so absolutely heady growth expectations are priced in, with lots of room for disappointment).

Second, the dark clouds of geopolitical tension darkened in 2023 with the Hamas-Israeli war. The risk of the U.S. being drawn into other regional conflicts may not be priced into equity prices (or oil).

Third, the yield curve remains inverted, so it is perhaps too early to take a victory lap. It would be one of the first, if not the only, time that the Fed engineered a normalization of inflation without needing to trigger a recession, so a bit of humility is warranted. It may be that the "inevitable" recession of 2023 has simply been pushed out further. We cannot be dismissive of this potentiality.

Still, we can celebrate…a little. Stocks have recovered brilliantly, and pockets of the U.S. market remain quite attractively priced. REITs rebounded nicely and were one of the best-performing asset classes in the fourth quarter. Bond prices have normalized and are now better positioned to do what bonds do best - pay a decent interest rate and act as a decent recession hedge.

We hope you all had a healthy and happy holiday season. Now it's back to work.

About Pete Chiappinelli, CFA, CAIA, Chief Investment Officer

Pete is Chief Investment Officer at the firm. He is focused primarily on Asset Allocation in setting strategic direction for client portfolios. Pete has 30 years of experience in research, investment strategy, and thought leadership regarding the management of multi-asset class portfolios, inclusive of equities, fixed income, and alternatives. His work has been featured in leading financial publications such as *The Wall Street Journal*, *The New York Times*, *Barron's*, and others in Canada, Europe, and Asia. His market commentaries have been featured at major industry conferences, in TV documentaries on capital markets history, and on social media outlets. Prior to joining Ballentine Partners in 2022, he was a Senior Portfolio Strategist on GMO's Asset Allocation team. Prior to that, he was an Institutional Portfolio Manager at a specialized unit within Fidelity Investments and was the Managing Director of Institutional Investment Strategy & Research at Putnam Investments. He is a graduate of Carleton College and holds his MBA from The Wharton School at the University of Pennsylvania. Pete holds the Chartered Financial Analyst (CFA) designation, is a member of the CFA Institute and CFA Society Boston, and he holds the CFA Institute Certificate in ESG Investing. He also holds the Chartered Alternative Investment Analyst (CAIA) designation and was the founding President of CAIA Boston. Pete lives in Hingham, MA with his wife, Cheryl, and enjoys travel, cooking (definitely not a "foodie," but a "foodie wannabe"), sourdough breadmaking, and conjuring up ways to embarrass his three children.