Making Sense of Finance

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Fourth Quarter 2023 Review

STOCK MARKET

US stock markets ended 2023 on a high note. After a miserable third quarter, stocks in the fourth quarter staged a strong comeback with nine straight weeks of consecutive gains in the S&P 500 index, an event not seen since early 1994. That index came within 1% of its all-time high with a gain of over 11% in the fourth quarter. Other major stock indexes also had solid returns last quarter, the Dow Jones Industrial Index gained over 12% and the Nasdaq Composite rose over 13%. For the year, the S&P 500 returned 24.2%, making up for 2022's 19.4% decline, which resulted in basically flat returns for a two-year period. These returns are somewhat deceiving for the performance of a typical stock. The median return of a stock in 2023 differed from the aggregate index return by 16%, which was the largest gap in the index versus the average stock performance since the tech bubble of the late 1990's. An often talked about topic during a presidential election year is what the typical stock market performance is in those years. Since 1952, the S&P 500 has averaged a 7% gain during presidential election years. Also, the S&P 500 has not declined in a re-election year, in which an incumbent president is on the ballot. There is an average gain of 12% during those election years.

In contrast to how they performed the first nine months of 2023, REITs (real estate investment trusts) were the best performing sector last quarter with a gain of over 17% benefitting from the decline in intermediate to long-term interest rates in the fourth quarter. Technology stocks outperformed the overall market as they did all year with that sector rising 17% last quarter. Stocks in the financial sector did well, also increasing over 13% the last three months of 2023. Energy stocks were the only sector to decline in value in the fourth quarter, with a loss of over 7%. Consumer staple and health care stocks, though showing positive returns, did not perform as well as the overall market. Investors were in a risk-on mode, hoping we have seen the last of the Fed fund rate increases and optimistically looking for multiple rate cuts in 2024.

Foreign stock markets also rebounded in the fourth quarter. The MSCI EAFE index, a measurement of stocks in

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Everyone and their neighbor has an opinion. At Karagosian Financial Services, we have a combined 40 plus years of investment experience. We have seen the markets at their highest highs and lowest lows. Through this newsletter we attempt to convey our opinions on current events in the investment world and their likely outcomes. Forecasting is inherently difficult and our advice is geared toward making sensible and prudent choices based on logic and experience, and not based on emotion.

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developed countries, gained 10% last quarter when measured in US dollar terms. In contrast to the previous quarter, measuring performance in US dollar terms helped returns as the dollar weakened, driven by the recent decline in interest rates in the U.S.as the Fed Fund rate is expected to be cut in 2024. In local currency terms, the market results weren't as robust. The Japanese market fared better than most, while the UK stock market, although still positive lagged many of their developed country market counterparts. Emerging markets which typically do well in a risk-on environment had positive returns in the fourth quarter as measured by the MSCI Emerging Market index but were not as impressive as developed country stock markets.

BOND MARKET

Stocks were not the only asset class that rallied in the fourth quarter. Bond prices reacted well to the general consensus that the Federal Reserve was finished raising rates. In addition the Federal Reserve committee members signaled a good probability that the Fed Fund target rate would be cut in 2024, perhaps multiple times. The Federal Reserve held the Fed Fund target rate steady at their December meeting at 5.25-5.50%. However, the anticipation of rate cuts caused interest rates to decline across the yield curve (bond prices increased). After showing losses on a year-to-date basis in the beginning of the last quarter, bonds rallied in November and December. The Bloomberg Barclays US Aggregate bond index had a total return of over 6% in the fourth quarter and was able to close the year in positive territory with a total return of 5.5% for 2023. The Ten-Year Treasury peaked at 4.99% in mid-October, but the yield declined dramatically from there and ended at 3.88%, (exactly where it started 2023) and 71 basis points lower than the end of the third quarter.

Corporate bond spreads tightened in the fourth quarter as their bond prices increased more than Treasury prices. Lower quality higher yielding bonds (among the top performing sectors for the year) performed better than investment grade corporates and intermediate term bonds had better returns than shorter term bonds last quarter. With this fourth quarter rally, bonds avoided a third straight year of losses.

OUTLOOK

First, we were right; there was no recession in 2023 despite all the media pundits. The prevailing sentiment is that inflation is under control now and declining and that the Federal Reserve will soon lower rates. However, recent mixed inflation figures have increased volatility and shaken investors' belief in an early cut in interest rates this year. While we agree that inflation will be tamer in 2024 and that rates will probably come down, we are also not assuming that it will happen in a straight line. In addition, we also take the Fed's 2% inflation rate goal out to 2025 with a grain of salt. If they could be so accurate and have that much control, inflation would never have skyrocketed in the first place, right?

Another factor that is brought up in the media that could disrupt the markets is the Presidential election which is drawing closer. If history serves as a guide, neither Democrat or Republican parties in power have yielded any substantial difference in market results. For example, both Biden and Trump have both presided over mostly a net positive stock market.

Stocks remain our favorite asset class, followed by short-term bonds, then real estate. Recall that valuation is rarely the determining factor for the stock market's direction. Rather, earnings over history is the highest correlation to market performance. Even with the stock market's strong performance in Q4, we think there is room to run.

Near-riskless returns of 4%-5% in Treasuries notes represent a very attractive option, in our view, and the short duration limits its sensitivity to changes in rates. While there are still pockets of strength in the real estate market, particularly in the residential and retail sector, the enormous office vacancy rates continue to make us uneasy. The national office vacancy rate stands at just about 20%, a record high, according to Moody's Analytics. Even with rates coming down, we doubt that mortgages will reach the record lows of 2020/2021 and offer "free" money to borrowers.