

Clearing the Real Rate Path

Year-End 2023 Market Commentary
and 2024 Outlook

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Economic Outlook: Slowing Economic Growth Aided by Monetary Easing and Fiscal Spending



Soft Landing in Sight as Disinflation Opens Door for Aggressive Fed Rate Cuts in 2024:

1. Fixed income markets anticipate 6-7 cuts to the Federal Reserve benchmark rate throughout 2024.
2. Despite strong consumer spending and healthy labor markets, decelerating inflation provides pretext for Fed rate cuts.
3. Optimistic consensus outlook for U.S. earnings growth of annualized 11-12% over next two years.



Key Risks to the Disinflation Narrative:

1. Near-term supply-induced shock that arrests disinflation.
2. End demand remains strong even in the face of higher rates.
3. Housing appreciation starts to pick up with lower rates.
4. Positive fiscal spending impulse in an election year means more deficit spending and bond issuance.
5. Post-pandemic recovery in labor productivity proves to be transitory.



2024 GDP Bloomberg Consensus:

1. US: +1.3% (↓ from +2.4% projected for CY2023)
2. Europe: +0.5% (= from 0.5% projected for CY2023)
3. Japan: +0.8% (↓ from +2.0% projected for CY2023)
4. China: +4.5% (↓ from +5.2% projected for CY2023)

What Happened and What to Do About It

- We maintain a neutral/cautious outlook on equities and risky fixed income due to higher valuations (lower risk premiums) that afford smaller margins of error in the event a soft landing does not occur.
- Investors should increase their diversification by allocating to fixed income and equity alternatives such as real estate and commodities so as to reduce overall portfolio volatility in the face of a multitude of economic and monetary scenarios.
- Investors looking to put new money into the markets should consider a dollar cost averaging program and tilt towards areas of the market offering more balanced risk-reward.
- 2023 was a notable year with respect to not only the strength of the global equity rally coming off a dismal 2022, but in its narrowness dominated by mega cap technology stocks – the perceived beneficiaries of significant capital deployment to fund generative artificial intelligence (AI) initiatives.
- 2023 was a narrow year with respect to divergence between a handful of technology mega cap growth stocks, as proxied by the NYFANG+ Index (+96.4% in 2023), and the broader markets (S&P 500 +26.3% and S&P Small Caps +16.9%). Global markets remain more attractive versus U.S. large caps, primarily mega caps which have priced in a blue sky scenario of unmitigated spending on AI.
- If the Fed pursues the easing campaign anticipated by the markets (6-7 rate cuts in 2024), then rate-sensitive segments such as small caps, cyclicals, financials, and real estate as well as those with marginal balance sheets would likely benefit. A weaker U.S. dollar makes foreign markets and hard assets (i.e. commodities) more attractive.
- Despite the year-end rally in fixed income as global interest rates dropped from late Autumn peak levels, real (inflation-adjusted) bond yields remain positive and attractive. Should the Fed pursue its rate cut campaign, then the current high rates offered by short-term vehicles such as money markets could be cut nearly in half within the next two years.
- Corporate credit risk as expressed by yield spreads above comparable government rates has declined in anticipation of a benign financing environment of lower rates but a smaller chance of an outright recession that would stress corporate balance sheets. Should the Fed pursue its rate cut campaign, then more of the yield offered by risky fixed income would compose of credit risk as opposed to base interest rates. As such, we are more cautious on corporate credit risk while still favoring structured finance (asset-backed, mortgage-backed) securities with more favorable valuations.
- Risk premiums as expressed by implied volatility from option pricing have also compressed to well below historical average levels, suggesting that investors selling volatility through covered call writing programs might consider other de-risking alternatives such as reducing overall equity allocations and/or raising cash.

Update Capital Market Assumptions

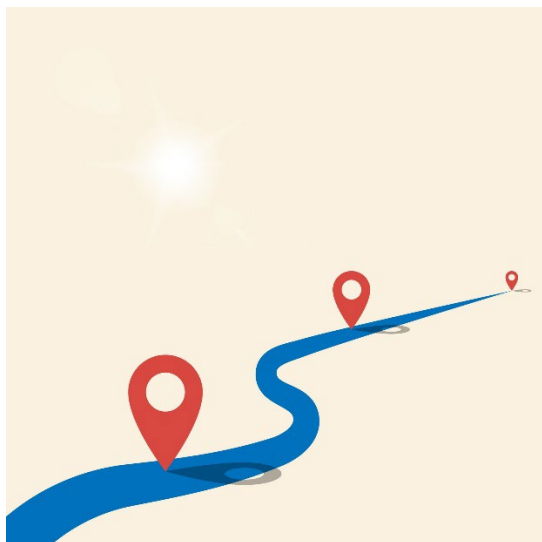
- Freedom forecasts that a 60/40 portfolio consisting of Global Stocks and US Investment Grade Bonds is projected to return approximately 6.7% nominal return (4.5% inflation-adjusted) over the long run based on year-end valuations. 6.2% (4.0% inflation-adjusted) for a U.S. stock-only portfolio, using 2.2% for long-term inflation forecast.
- Our long-term expected nominal rate of return for global equities: 8.2% (6.0% earnings yield +2.2%). For the U.S. equities: 7.3% (5.1% earnings yield +2.2%)
- U.S. Fixed Income: Projected Yield-to-Worst on Bloomberg/Barclays US Aggregate Bond Index is 4.5% (down from 4.6% last year) and +2.3% on a long-term inflation-adjusted basis.

Key Benchmarks: Performance and Characteristics as of 12/31/2023

Equities	MTD	QTD	YTD	1-Yr Fwd P/E: Current vs 10-Yr Range			
S&P 500	4.5%	11.7%	26.3%	19.7x	14.6x	22.9x	
MSCI EAFE	5.3%	10.4%	18.2%	13.7x	11.2x	18.2x	
MSCI Emerging	3.9%	7.9%	9.8%	11.8x	9.5x	15.3x	
Fixed Income	MTD	QTD	YTD	Real Assets	MTD	QTD	YTD
Bloomberg U.S. Aggregate	3.8%	6.8%	5.5%	US REITs	8.8%	17.9%	11.3%
Bloomberg U.S. High Yield	3.7%	7.2%	13.4%	GSCI Commodities	-3.3%	-10.7%	-4.3%
Bloomberg Global Agg ex U.S.	4.5%	9.2%	5.7%	GSCI Prec Metals	0.5%	11.0%	11.5%

Data Source: Bloomberg

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Source: istockphoto.com

“So we’re...aware of the risk that [the Federal Reserve] would hang on too long. ... we’re very focused on not making that mistake. ... we’ve come back into a better balance between the risk of overdoing it and the risk of underdoing it. Not only that, we were able to focus hard on the—on the price-stability mandate.”

– Federal Reserve Chair Jerome Powell, Post-FOMC Press Conference, 12/13/2023¹

¹ [Post-FOMC Press Conference Transcript, 12/13/2023](#)

Note to readers: we have sectioned the 2023 Year-End Market Commentary and 2024 Outlook accordingly:

1. Big picture overview and long-term capital market assumptions (pp 5-17)
2. 2023 calendar year asset class returns and quarter-by-quarter recap (pp 18-24)
3. December 2023 Monthly Review (pp 25-30)
4. 4Q and CY-2023 performance charts and notable exhibits (pp 31-40)

The risk-on rally that we witnessed in the 4th quarter started with a speech from Fed Governor and current voting FOMC member Christopher Waller, in which he strongly hinted that the Fed was finished with its rate tightening campaign and that falling inflation would provide sufficient pretext to start easing policy even in the face of strong employment². As Jerome Powell implied at the December FOMC press conference, the Fed is more willing to be proactive on policy shifts so as to minimize the risk of overtightening in the face of slowing nominal economic growth as long as disinflation makes meaningful progress towards the Fed’s long-term goals.

In hindsight, the Waller speech turned out to be the Fed Pivot, where the equity and bond markets started to price in the beginning of the Fed easing campaign by pulling forward expected rate cuts in 2024 as well as increase the number of expected rate cuts. The 4th quarter witnessed a significant risk-on rally with the S&P 500 rallying nine weeks in a row, U.S. small caps outperforming large caps to reflect a broadening of market breadth, and long-term Treasury rates dropping over 1% from peak levels seen in early October. The Fed has laid the course to lower (real) rates throughout 2024, and the market not only priced in that path, but ran ahead of it as the 6-7 rate cuts being priced in the Fed Futures curve (**Figure 1**) are higher than the three rate cuts expressed in the latest FOMC dot plot forecasts.

Figure 1 – The Path Towards Lower Rates: Fed Funds Are Pricing In 6-7 Rate Cuts in 2024

Region: United States »		Instrument: Fed Funds Futures »				
Target Rate	5.50	Pricing Date	12/29/2023 📅			
Effective Rate	5.33	Cur. Imp. O/N Rate	5.327			
Meeting	#Hikes/Cuts	%Hike/Cut	Imp. Rate Δ	Implied Rate	A.R.M.	
01/31/2024	-0.160	-16.0%	-0.040	5.287	0.250	
03/20/2024	-1.003	-84.3%	-0.251	5.077	0.250	
05/01/2024	-2.075	-107.2%	-0.519	4.809	0.250	
06/12/2024	-3.118	-104.4%	-0.780	4.548	0.250	
07/31/2024	-3.960	-84.2%	-0.990	4.338	0.250	
09/18/2024	-4.918	-95.8%	-1.229	4.098	0.250	
11/07/2024	-5.630	-71.3%	-1.408	3.920	0.250	
12/18/2024	-6.303	-67.2%	-1.576	3.752	0.250	
01/29/2025	-6.950	-64.7%	-1.738	3.590	0.250	

Source: Bloomberg World Interest Rate Probability (WIRP)

² “[Something’s Got to Give](#),” Governor Christopher J Waller, 10/18/2023

The bond market is also getting ahead of expected Fed easing implied by the drop in long-term inflation expectations embedded in the yields between Treasury Inflation Protected Securities (TIPS) and nominal Treasury bonds. **Figure 2** displays the expected real rates over the next 10 years with a notable drop in the 4th quarter of 2023 following several benign inflation releases that saw core inflation of 3.2% (November PCE release), well below the Fed's initial forecast of 3.8%.

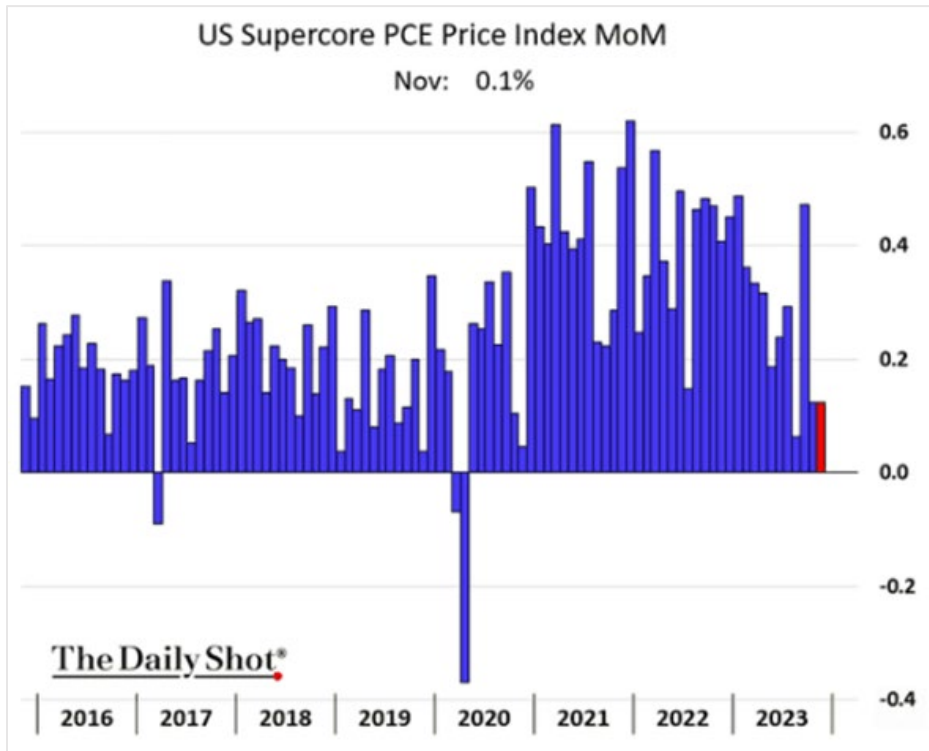
Figure 2 – Long-Term Real Rates Dropped in the 4th Quarter



Source: Bloomberg World Interest Rate Probability (WIRP)

Indeed, the Fed has a notable disinflationary tailwind to engage in moderate easing without the collapse in economic and hiring activity that served as prior preconditions for the Fed to pivot from tightening to easing. Supercore PCE (core PCE ex housing) has decelerated throughout the 2nd half of this year (**Figure 3**), and some analysts, such as Tim Duy of SGH Macro, suggest that the Fed may be at risk of falling behind the disinflationary curve just as they had fell behind the post-pandemic inflation surge. The only major component holding up trailing headline inflation is housing which is expected to moderate further into 2024 to reflect real-time deceleration in rental and leasing rates.

Figure 3 – Clear Deceleration in Core Inflation Driven by Goods and Services

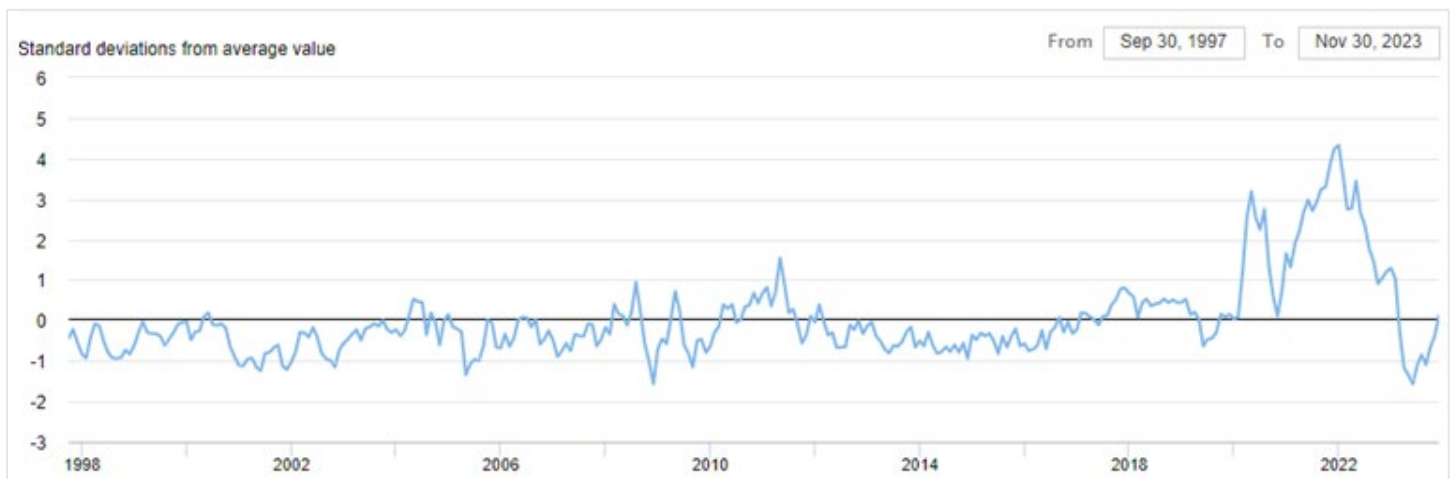


With the disinflationary path forward towards lower rates, we believe there are several potential road hazards that could make the drive towards lower rates somewhat bumpy:

1. Near-Term Supply-Induced Shock that Arrests Disinflation

The New York Fed maintains the Global Supply Chain Pressure Index³ (Exhibit 4) that helps track supply constraints (i.e. transportation, storage) “associated with goods and producer price inflation.” The notable decline from peak post-COVID constraint levels in 2020-2021 that helped drive down core goods pricing has reversed over the recent period, possibly reflecting the rerouting of global containership traffic out of the Red Sea as a result of Houthi attacks on shippers. This may prove to be transitory, and any near-term ‘surprises’ on the core goods inflation front could be dismissed as such. However, the optics of an unexpected inflation surprise coming from the main contributor of trailing disinflation would make it more difficult for the Fed to pursue an easing campaign implied by market pricing. Some contribution from the demand side (waning demand) would help make the disinflation narrative more sustainable.

Figure 4 – An Uptick in Global Supply Chain Pressures Could Lead to Higher Goods Prices



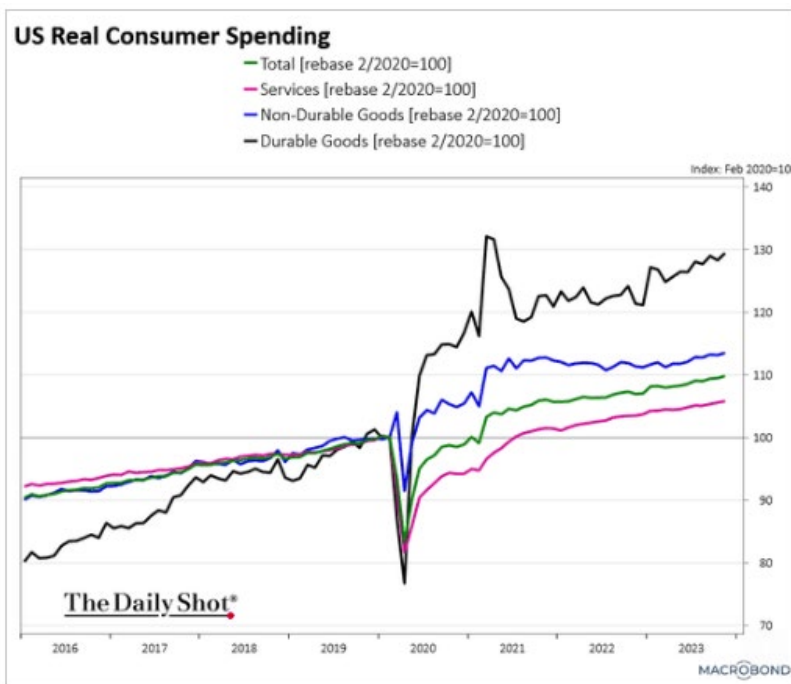
Source: New York Federal Reserve

³ [New York Fed Global Supply Chain Pressure Index \(GSCPI\)](#)

2. End Demand Remains Strong Based on Real (Inflation-Adjusted) Consumer Spending

For all the talk of an expected economic slowdown, the U.S. consumer keeps spending even if other indicators such as credit card usage and delinquencies point towards more exhaustion and borrowing stress. **Figure 5** displays real consumer spending trends which reveal a healthy appetite for goods and services despite higher interest rates and a softening labor market. With reports of inventories having been drawn down and potential supply chain stresses starting to build, the risk of a 2nd wave of inflation, even if transitory, seems greater than non-significant.

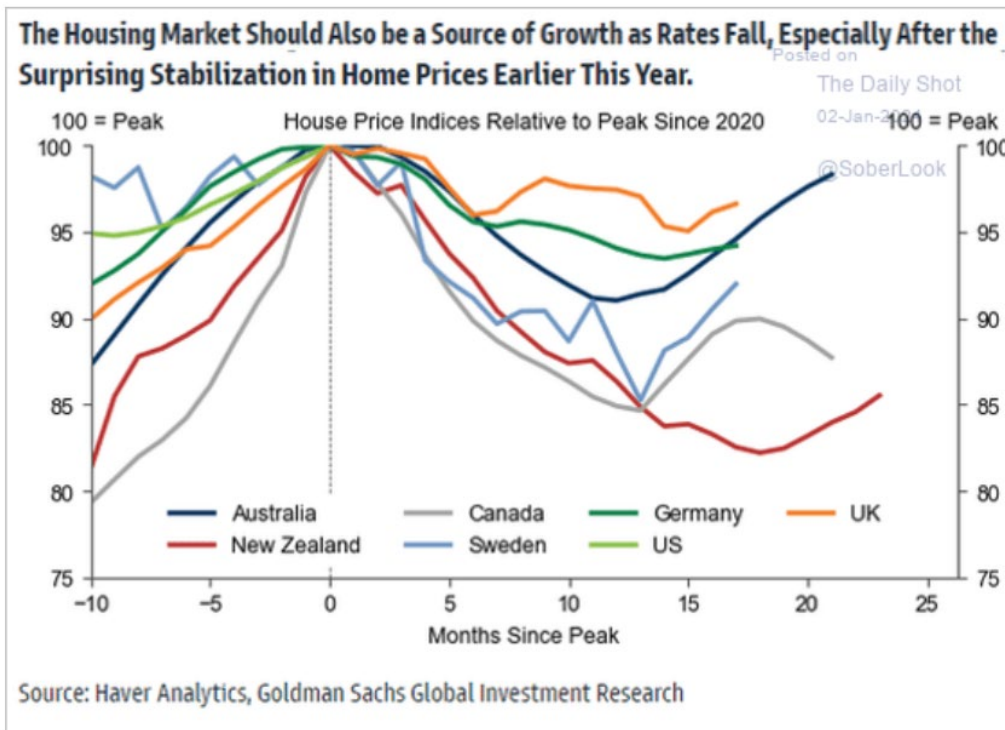
Figure 5 – The Demand Story Remains Robust with Real Consumer Spending Trending Higher



3. Housing Appreciation May Start to Pick Up with Lower Rates

It is debatable whether lower rates would fuel further housing appreciation, where unaffordability remains at record levels, just as higher rates did not result in lower prices, as overall inventories remain well below the peak levels seen pre-Great Financial Crisis (GFC) of 2008-2009. But housing price indices are starting to turn higher (**Figure 7**) just as interest rates have dropped, with lower borrowing costs offset by higher prices. As long as housing demand remains constant with a robust job market, then housing appreciation could arrest the gradual decline in the shelter components within consumer price indices, further complicating the optics of an aggressive rate cut campaign.

Figure 7 – Global Housing Prices Turning Higher in Anticipation of Lower Rates



4. U.S. Deficit Spending Remains at Record Levels as the Treasury Would Need to Issue More Bonds to Fund Spending (as Opposed to Bills)

The U.S. government will continue record level deficit spending even as U.S. Gross Domestic Product (GDP) continues to grow. This is an election year of course, so both political parties have little incentive to press the brakes on fiscal impulse. Even if deficit spending climbs down from the peak pandemic levels, the accumulated debt remains at post-World War II levels (**Figure 8**). And the U.S. Treasury has likely hit its limit on how much of the current deficit can be financed with short-term Treasury Bills. Now that long-term rates have come down from peak levels in late Autumn, Treasury is expected to issue more longer-dated debt to finance ongoing deficit spending (**Figure 9**) barring a major pullback in government spending.

Figure 8 – U.S. Debt and Deficit Spending (% of GDP) Remains Near Peak Levels

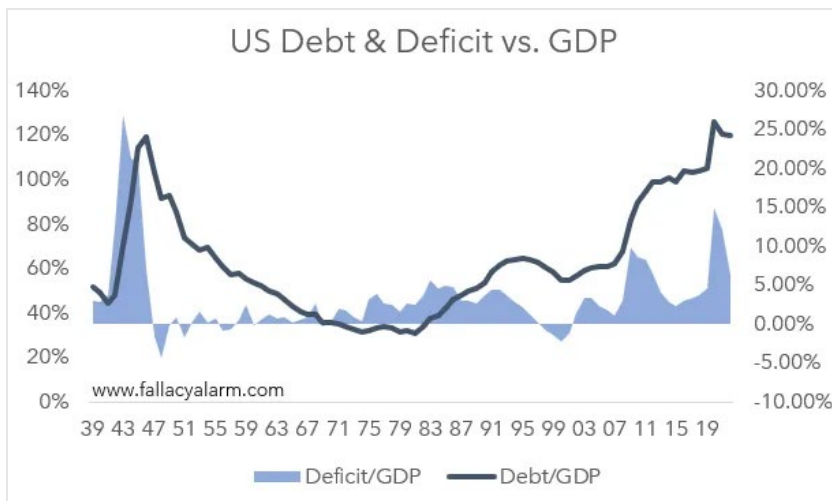
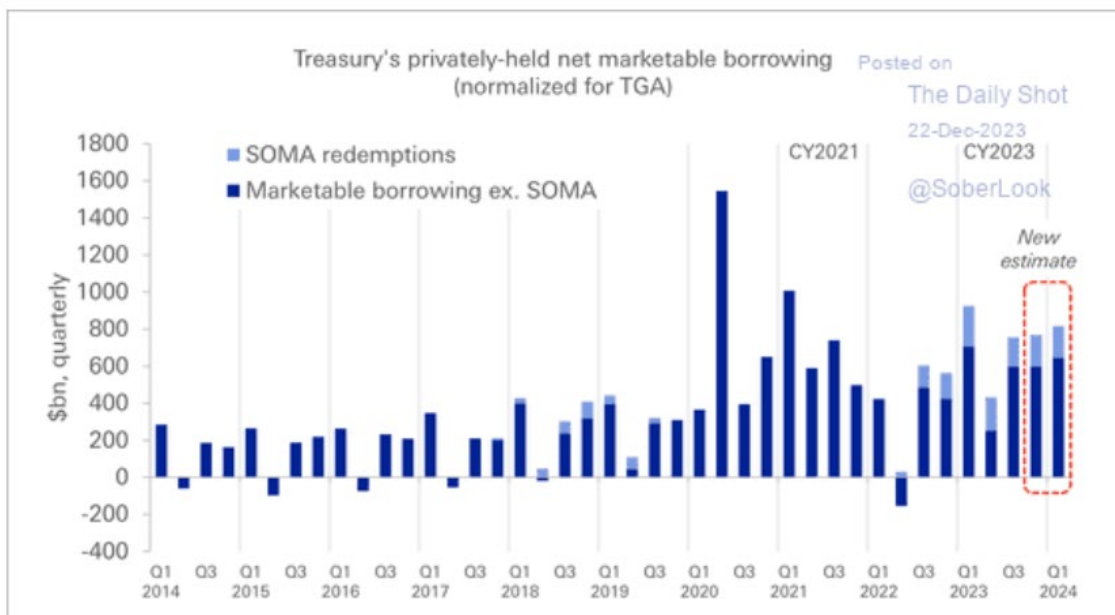


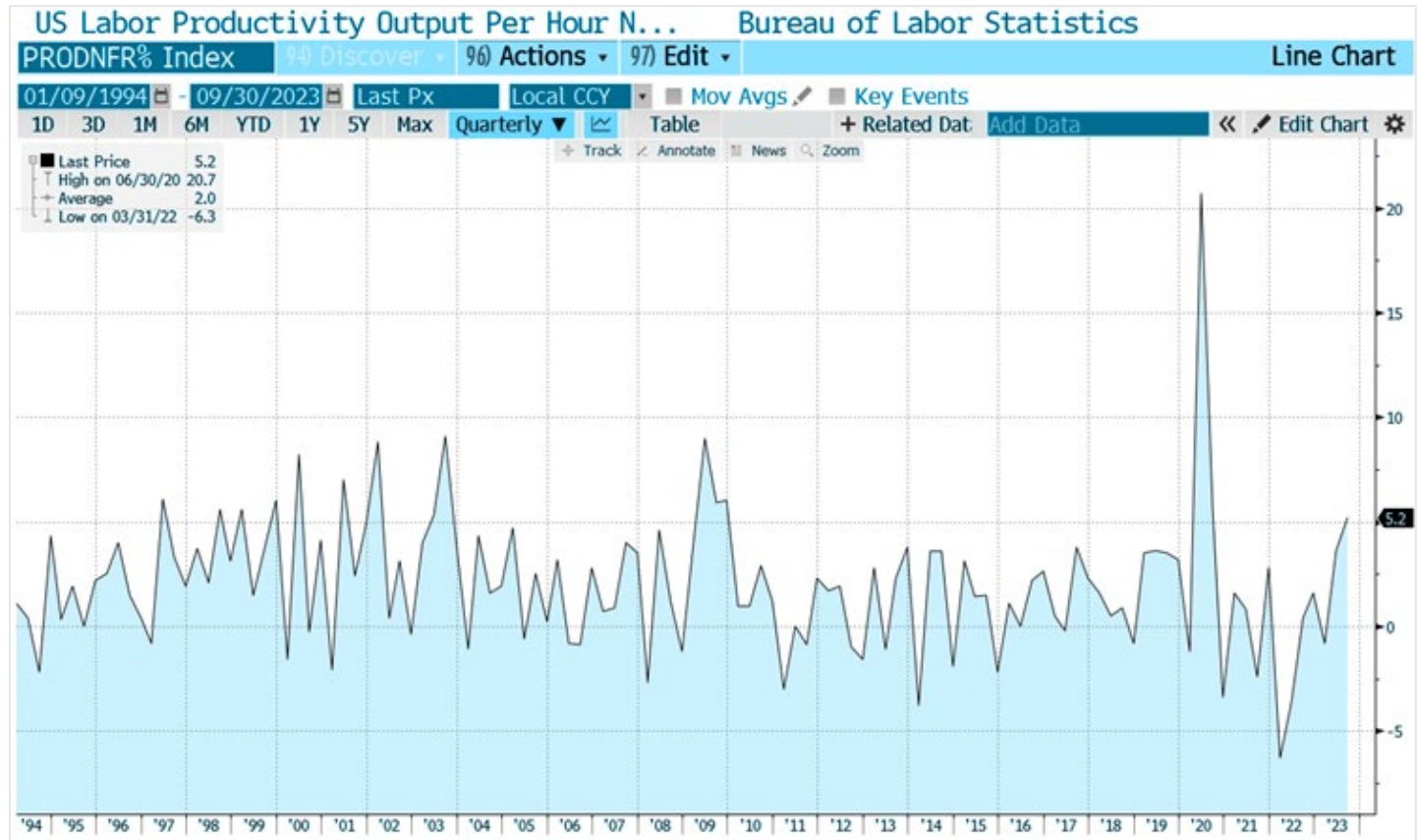
Figure 9 – On An Absolute Basis, U.S. Borrowing Remains Near Post-Pandemic Peak Levels



5. Post-Pandemic Recovery in Labor Productivity May Prove to Be Transitory

Even though wage growth remains elevated at 4-5% per the Atlanta Fed Wage Tracker, U.S. productivity has rebounded with a strong 5.2% 3Q2023 print (**Figure 10**). Productivity serves as the cornerstone for the soft-landing narrative that sees disinflation not resulting from a severe economic downturn. Should productivity prove to be transitory and revert back to below trend levels, then higher labor costs could feed their way back into higher prices.

Figure 10 – Will the Sharp Recovery in Productivity Prove to Sustain Itself?



Source: Bloomberg

6. The Geopolitical Landscape Remains Murky at Best

Finally, ongoing flare-ups across the Middle East and potential new flare-ups in Southeast Asia would muddy the geopolitical landscape already darkened by the Russia/Ukraine conflict, which shows few signs of resolution. One can argue that geopolitics ranks low on the Kept-Awake-at-Night meter based on little to no uncertainty implied by cross-asset volatility and the lack of demand for safe-haven assets. But the current market narrative remains wedded to the post-WWII order of U.S.-governed globalization, and further cracks in this order could surface in unexpected spikes in market volatility.

Market Outlook: Cautious Due to Narrower Risk Premiums (Thin Margin of Error) In the Event a Soft Landing Doesn't Materialize

Based on our Capital Market Projections for 2024, Freedom Investment Management (“Freedom”) remains cautious on equities and risky fixed income due to higher valuations (lower risk premiums) from beginning 2023 levels despite the greater optimism over Fed policy, economic growth and earnings. We continue to emphasize strategic asset allocation as a core investment discipline and that time horizons should be properly matched with the inherent riskiness of underlying investments. Investors looking to put new money into the markets should consider a dollar cost averaging program and tilt towards areas of the market offering more balance risk-reward (see below).

2023 was a notable year with respect to not only the strength of the global equity rally coming off a dismal 2022, but in its narrowness dominated by mega cap technology stocks that are expected to benefit from significant capital spending to fund generative artificial intelligence initiatives. It was only after the Fed cleared the path for easier policy in 2024 that the market started to broaden out with small caps outperforming large caps, and foreign markets outperforming on U.S. dollar weakness. Indeed, 2023 was a narrow year with respect to divergence between a handful of technology mega cap growth stocks, as proxied by the NYFANG+ Index (+96.4% in 2023), and the broader markets (**Figure 11**).

Figure 11 – Market Narrowness Encapsulated by NYFANG+ versus the Broader Markets



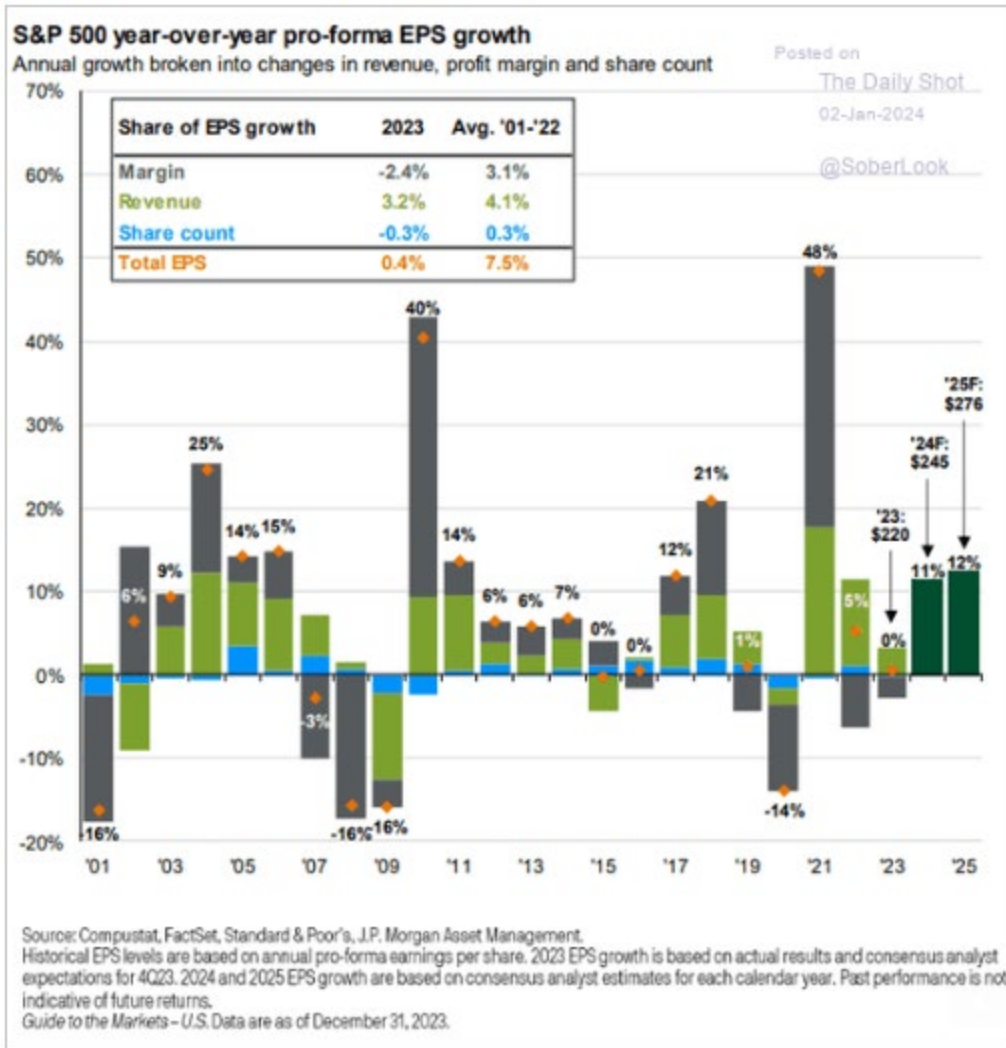
Source: Bloomberg World Interest Rate Probability (WIRP)

Clearing the Real Rate Path

Year-End 2023 Market Commentary and 2024 Outlook

Wall Street analysts remain optimistic on the earnings growth outlook over the next two years – a sentiment that hasn’t changed since early 2023 as analysts expected S&P 500 earnings to grow 11-12% annualized over the next two years (Figure 12).

Figure 12 – Consensus Outlook Anticipates 11-12% Annualized Earnings Growth Over Next Two Years

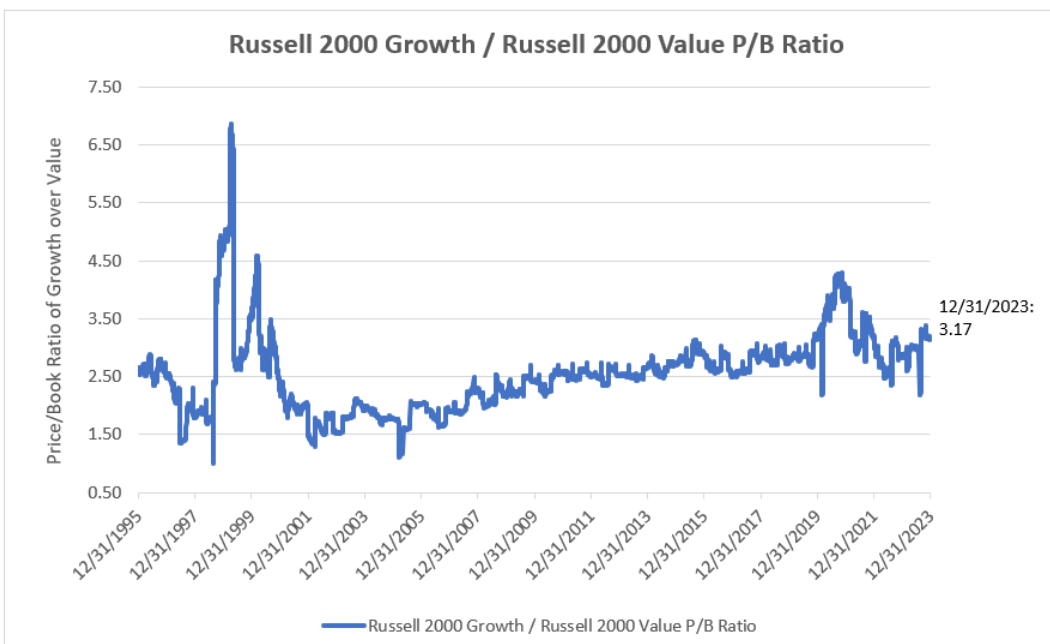
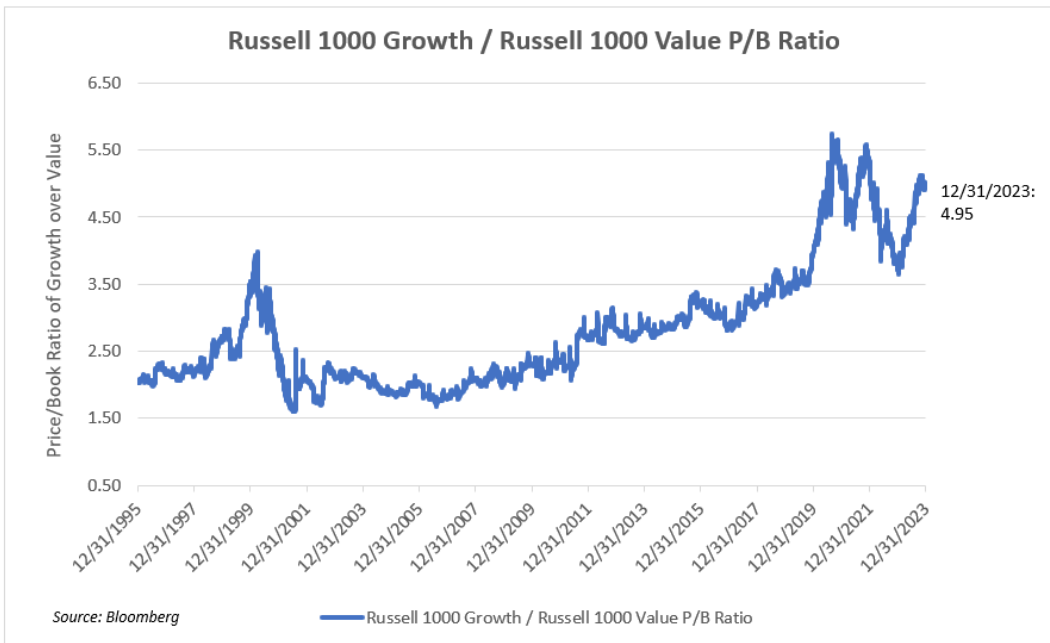


Clearing the Real Rate Path

Year-End 2023 Market Commentary and 2024 Outlook

Despite the strong risk-on rally in the 4th quarter in anticipation of Fed rate cuts, global markets remain attractive outside of U.S. large caps, primarily megacaps which have priced in a blue sky scenario of unmitigated spending on artificial intelligence initiatives. **Figure 13** displays the price/book multiple differences between growth and value for large caps (Russell 1000) and small caps (Russell 2000). The value discrepancy is more evident in large caps than in small caps, but if the Fed pursues the anticipated easing campaign, then rate-sensitive segments such as small caps, cyclicals, financials, and real estate as well as those with marginal balance sheets would likely benefit. A weaker U.S. dollar makes foreign markets and hard assets (i.e. commodities) more attractive.

Figure 13 – 2023 Saw Growth Price/Book Multiples Widen Versus Value



Capital Market Projections Updated for 2024

We enter 2024 with about the same nominal and real (inflation-adjusted) interest rate backdrop as existed when we entered 2023 where real interest rates across the U.S. maturity curve are still positive based on implied inflation expectations priced between U.S. TIPS and nominal Treasuries. Despite the elevated real rate environment, tighter borrowing conditions did not stop consumers spending, businesses hiring, and global stocks rallying, with the latter enjoying a three-point multiple expansion on forward earnings from the beginning of the year (16.7x price/earnings) to the end (19.7x price/earnings). Cash is still attractive with short-term cash vehicles yielding around 5% (opposed to 0% at the end of 2021), but those high rates may prove to be ephemeral in the face of an expected Fed easing cycle throughout 2024 that is expected to see short-term rates drop nearly 2%.

Following a flat year for overall S&P earnings in 2023, the earnings outlook for 2024 looks rosier for S&P 500 companies, although Wall Street had expected high single digit earnings growth in 2023 (likely flat when 4Q23 results are released). The aggregate profit margin is expected to end the year around 11.6%. For CY 2024, analysts expect S&P earnings growth of 11.5% on top of revenue growth of 5.5%⁴, as optimism over monetary easing and secular growth in technology spending are expected to overcome a slowdown in nominal economic activity. So positive earnings growth could help equity valuations remain near their elevated levels (based on trailing 10-year history), but where interest rates move in 2024 could help or hinder equity valuations heading into next year's elections, as would cost pressures on cyclical high profit margins.

Freedom believes that price matters over the long run and that what you pay today will influence the returns you realize over the long-term. Price can exert a long-term gravitational pull on expected returns. Long-term investors should remain fully invested as part of a strategic asset allocation built on risk-based investment programs. Unlike the beginning of 2023 where we were less cautious due to cheaper valuations in both equities and fixed income compared to 2021-2022, the current environment speaks to less attractive valuations across risk-based assets, despite more muted market volatility and expected lower rates heading into 2024 as the soft, disinflationary landing has become the consensus market scenario.

What follows are a series of forecasts for long-term expected returns across various asset classes. In the spirit of Fama/French and Jeremy Siegel ("Stocks for the Long Run") from University of Pennsylvania's Wharton School, Freedom derives its long-term forecasts from valuations currently priced into equity and fixed income assets.

⁴ [Factset Earnings Insight 12/15/2023](#)

Freedom Investment Management Long-Term Equity and Fixed Income Asset Return Forecasts

1. Start with MSCI All-Country World Index (ACWI) (Global Equities) and S&P 500 (US Equities) Price/Earnings Multiple Based on Consensus Next 12-Months Earnings (12/31/2023): 17.6x and 19.7x, up from 14.5x and 16.7x last year, respectively.
2. Invert the MSCI ACWI and S&P 500 P/E multiples to arrive at an earnings yield to generate a long-term real (inflation-adjusted) return forecast: 6.0% and 5.1%, down from 6.9% and 6.0% last year, respectively.
3. Long-term inflation expectations implied by 5-year/5-year breakeven rates between U.S. Treasury Inflation Protected Securities (TIPS) and nominal Treasuries: 2.2% (unchanged from last year).
4. Long-term expected nominal rate of return for global equities: **8.2%** (6.0% + 2.2%). For the S&P 500: **7.3%** (5.1%+2.2%)
5. U.S. Fixed Income: Projected Yield-to-Worst on Bloomberg/Barclays US Aggregate Bond Index is **4.5%** (down from 4.6% last year) and +2.3% on a long-term inflation-adjusted basis.
6. Projected Yield-to-Worst on Bloomberg/Barclays US High Yield Index: **7.4%** (5.2% on an inflation-adjusted basis). S&P Global Ratings Credit Research is projecting a 5% default rate in 2024⁵.

Combining all the above inputs, Freedom forecasts that a 60/40 portfolio consisting of Global Stocks and US Investment Grade Bonds is projected to return approximately **6.7%** nominal return (**4.5%** inflation-adjusted) over the long run based on year-end valuations. **6.2%** (**4.0%** inflation-adjusted) for a U.S. stock-only portfolio. One can potentially increase returns by investing in riskier asset classes such as small caps and high yield, but one would also be introducing more risk into the portfolios, even when accounting for diversification benefits.

⁵ [S&P Global Ratings](#)

2023 Asset Class Performance

Figure 14 displays the 2023 calendar year returns across risk-focused assets. 2023 turned out to be a flip of 2022 with the prior year's leaders (Energy, Commodities) this year's laggards. Growth-focused sectors (Technology and Communication Services) were among the top performers in 2023, performing well above most other investment styles, sectors, and regions. 2023 saw High Quality perform well ahead of the other major risk factors while small caps underperformed large caps. International Developed Markets (MSCI EAFE) outperformed Emerging Markets (MSCI EM). Emerging Markets and broader Asian underperformed primarily due to China, whose economy and industrial activity were weighed down its debt-burdened property sectors, weak consumer demand, and tightened regulations. Commodities posted a negative year with much of the weakness coming from lower energy prices.

Figure 14 – 2023 Calendar Year Returns for Risk-Focused Asset Classes

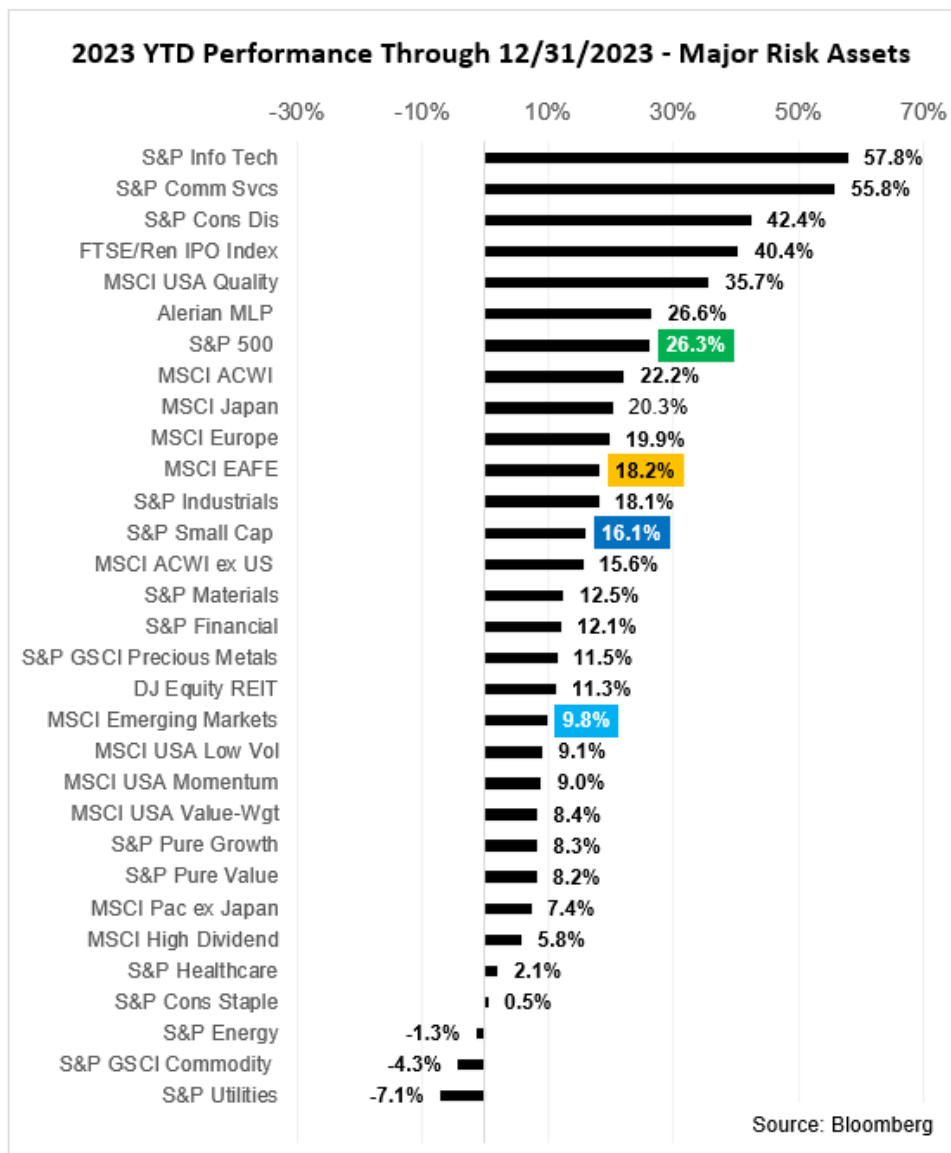


Figure 15 displays the 2023 returns across fixed income market sectors. Following a sharp drop in interest rates in the 4th quarter, global fixed income enjoyed a nice recovery from the 2022 sell-off, one of the worst calendar year performances in at least the past 70 years. International fixed income and emerging market debt outperformed as foreign currencies strengthened against the U.S. dollar late in the year. Municipal bonds outperformed as the borrowing costs of state/local issuers narrowed versus federal-issued debt. High Yield and Investment Grade Corporates outperformed as credit spreads narrowed throughout much of the year.

Figure 15 – 2023 Returns Across Fixed Income Markets

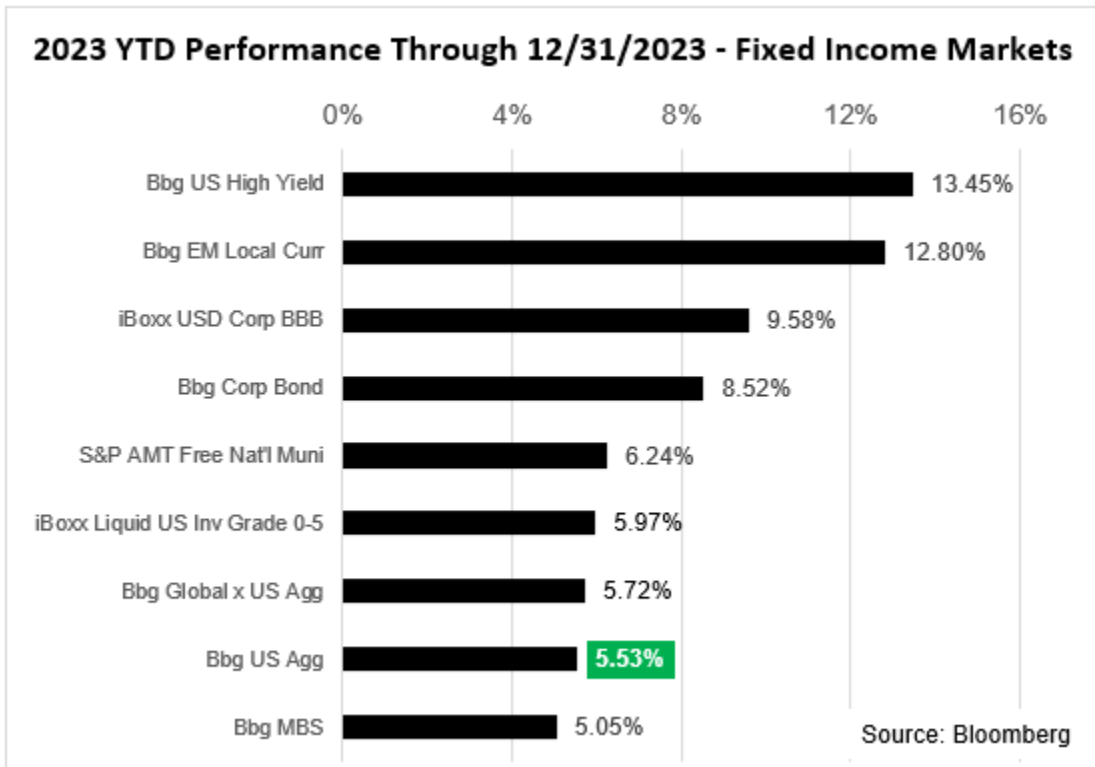
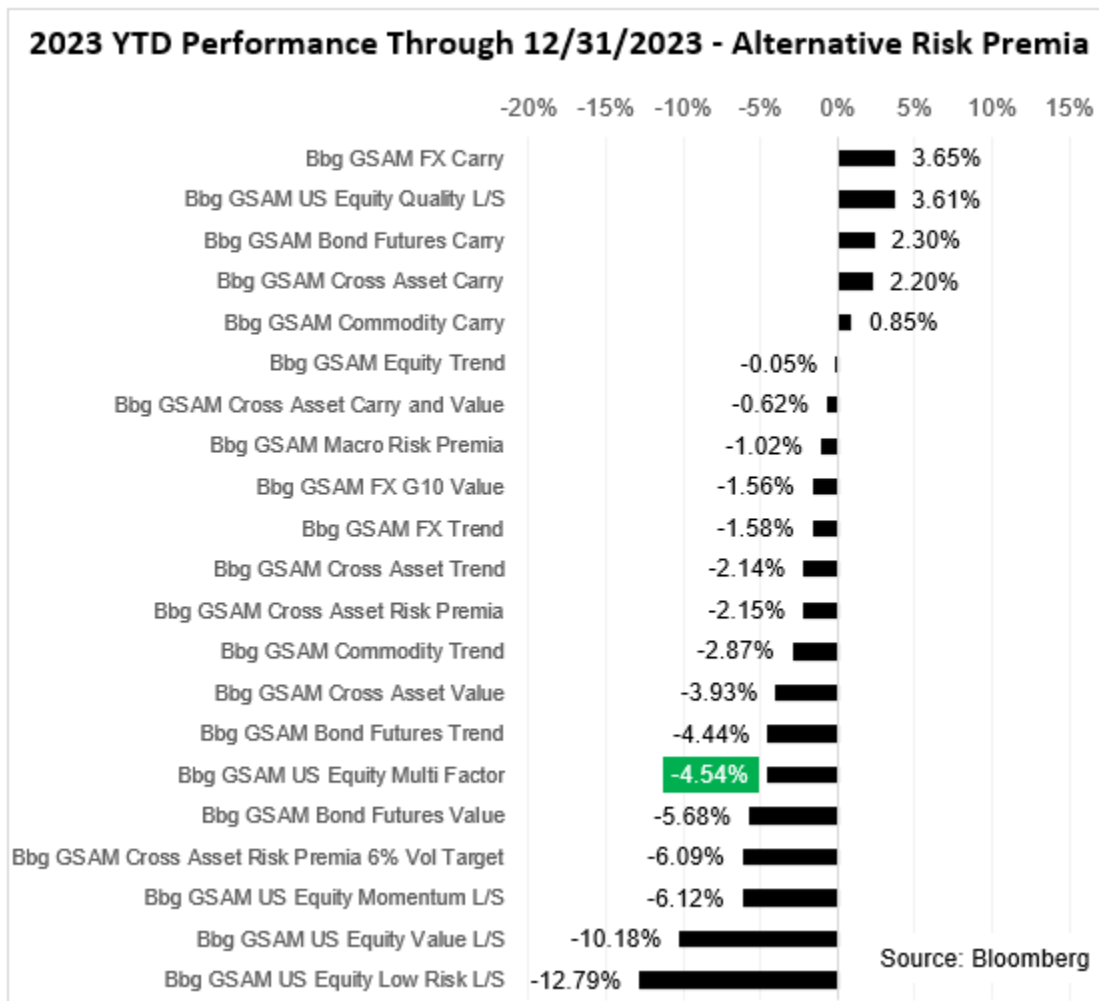


Figure 16 displays the 2023 returns for alternative risk premiums (value, carry, trend, and factors calculated by Bloomberg/Goldman Sachs Asset Management). It was a tougher year for alternative risk premia with L/S Quality the only factor posting positive returns (and that was mostly driven by tech). Carry strategies also performed well across different markets, whereas strategies focused on trend struggled.

Figure 16 – 2023 Returns Across Alternative Risk Premia



2023 Recap (Our Observations at the Time)

1st Quarter 2023: [Investors Flee for the Safety of Long Duration Assets](#)

Risk-based assets (both equity beta and fixed income duration) had a phenomenal start to 2023 as global equity valuations had risen despite corporate earnings pressure as operating costs had been rising faster than revenue growth while interest had dropped in anticipation of a global economic slowdown to be met with a reversal in central bank tightening. And unlike prior counter risk-on rallies such as early August 2022, there was little pushback by central bank officials to the renewal of the animal spirits that drove double-digit gains across many of 2022's most beaten down sectors such as stocks with the highest short interest, most unprofitable stocks, "meme" stocks, and Chinese technology stocks.

The outlook for the anticipated slowdown or recession in 2023 (which didn't happen) had been somewhat clouded by an increasing divergence between "soft data" (business surveys, consumer sentiment) and "hard data" (actual production, labor conditions, consumer purchases). The drop in business sentiment as expressed through surveys had been a function of residual pandemic shutdown effects such as demand surges, supply chain bottlenecks and higher input costs.

February saw the initial surge in the tech sector, especially companies with direct ties to the generative artificial intelligence movement following the launch of ChatGPT in November 2022. Generative AI had kicked off a new gold rush in future-tech, namely the buildout of artificial intelligence capabilities to enhance industrial productivity and competitiveness. Growth-minded investors had shifted their focus from digital assets/cryptocurrencies to the metaverse and now to artificial intelligence.

Sentiment favoring the No-Landing scenario had picked up momentum as short-term inflation expectations had risen over 3% with Fed Funds futures now pricing in a 5.5% terminal fed funds rate by the summer of 2023, up from 4.75% at the end of January. Long-term government bond yields had also surged from their year-to-date lows, reflecting a no-landing environment of elevated inflation that would not come down as fast as the market had initially expected.

The market wall-of-worry included the ongoing Russia/Ukraine conflict, the upcoming U.S. debt ceiling showdown (which would eventually be resolved), and debt servicing stress that was expected to hit the U.S. consumer such as the resumption of past-due student loan payments along with rising interest costs on auto loans and credit cards.

March witnessed the regional banking crisis with the failures of Silicon Valley Bancorp and Credit Suisse. The deposit beta and balance sheet duration-mismatch turmoil that plagued the banking sector (and was threatening life insurers and custodians) would weigh on investor sentiment for financial stocks even with the eventual success of backstop facilities such as the Bank Term Funding Program (BTFP). The FDIC was able to auction off some of the assets and business units of SVB Financial and Signature Bank. The U.S. banking system had experienced about \$500 billion in net outflows throughout March.

Essentially, the first quarter of 2023 saw a reversal of 2022 which saw inflation fears driving investors to favor cyclical value stocks and commodities while reducing exposures to long-duration assets such as expensive growth stocks and long maturity debt carried at historically low interest rates. This reversal would presage for what would come through the remainder of the year as investors fled for the safety of expensive growth technology stocks.

2nd Quarter 2023: [Pay Now. Grow Later](#)

Global stocks and risk assets started the 2nd quarter grinding higher, but U.S. megacap technology (soon to be labeled the Mag7) and consumer stocks continued their outperformance despite looming prospects of an economic slowdown where a majority of economists were still projecting a recession in 2023. Although 1Q2023 real GDP came in a healthy 1.1% (advanced reading) helped by strong personal consumption and government spending, gathering storm clouds around banking stress (deposit flight, commercial and consumer loan weakness) and the looming U.S. federal government debt ceiling showdown could prospectively create a negative feedback loop with lenders, businesses and consumers pulling back in the face of such uncertainty. Value stocks, particularly the banking and insurance sectors were weighted down by higher interest rates and commercial real estate risk, as they faced an uncertain prospect of regulatory restrictions (deposits, capital reserves) and more negative headlines as the FDIC placed First Republic Bank in receivership.

The narrowness of this year's market advance reached extreme levels as the equal-weighted S&P 500 Index experienced a near-historic level of underperformance versus the cap-weighted S&P 500 on a rolling 3-month basis. Markets represent the final arbiters of company valuation, but so far this year investors were behaving as if the only value worth assigning are the dominant technology and consumer growth names. For instance, Apple's market valuation alone exceeded that of the entire Russell 2000 company universe. As post-COVID global growth became less of a certainty and global events induced more economic volatility, investors seem to have flocked to these perceived tech-focused safe havens, viewed less susceptible to forces afflicting more traditional economic sectors (finance, industrial), smaller companies (witness the increasing haves vs have-nots within retailing), and regions outside the U.S. (economic weakness spreading across Europe and China).

A debt ceiling resolution negotiated by the Biden Administration and Congressional Republicans passed the U.S. House of Representatives and the U.S. Senate in time prior to the x date. The debt ceiling deal effectively froze the increase in government spending (albeit from a post-pandemic high levels) through 2025 in exchange for lifting the \$31.4 trillion ceiling to \$34 trillion through 2025 while reducing government deficits by \$1.5 trillion over a decade based on CBO projections versus baseline.

The U.S. economy's main workhorse, the consumer, was showing signs of a slowdown, but not a crash, although earnings releases across the retailers presented a mixed picture. According to the Bureau of Economic Analysis (BEA), inflation-adjusted (real) consumer spending continued its upward post-COVID trend while TSA checkpoint data revealed travel demand exceeding pre-COVID activity. Those expecting a recession kept delaying their timetable as long as consumer spending remained buoyant, helped by strong labor market conditions.

Although analyst estimates for the S&P 500 companies had been rising since the February low levels (much of that upward revision coming from optimism over tech-driven growth spending), sellside analysts were only projecting 0.9% (to be later revised down to flat) growth in earnings-per-share for CY2023, but a much better year for 2024 (11.4% growth). So, a strong recovery in earnings growth was being pushed out later in 2024 with 2023 treated as a wash year. The U.S. economy may very well muddle through the rest of 2023 in a no-landing scenario where the U.S. economy does not contract for quite some time. Bloomberg Economic consensus now revised their 2023 real GDP growth to 1.3%, up from 0.3% expected at the beginning of the year. The June FOMC meeting resulted in a hawkish pause that left the benchmark rate unchanged at 5.25% but with expectations that the Fed would like raise rates again at least two more times this year, which Fed Chair Powell reiterated during Congressional testimony.

3rd Quarter 2023: [Defense Caught Offsides](#)

The third quarter began with a continuation of the risk-on rally from the 2nd quarter that initially saw a counterrally in this year's laggards, notably Asian equities and global small caps; however, the optimism that fueled the initial market rally dissipated throughout the remainder of the quarter, despite further indications of slowing inflation, resilient economic growth activity, and rising earnings optimism over technology spending fueled by generative artificial intelligence. By the end of the quarter, real (inflation-adjusted) interest rates sharply rose, especially on the long end of the yield curve, pressuring interest-sensitive assets and foreign currencies and pushing up borrowing rates for consumers and businesses to levels not experienced since prior to the 2008 Great Financial Crisis.

At the July FOMC, the U.S. Federal Reserve raised the target of their benchmark overnight rate to 5.50% after having paused at the June FOMC to assess the economic and financial system conditions, and potential fallout from the mid-March regional bank failures. Despite raising rates at the sharpest and quickest pace when viewed versus prior rate hike cycles, global risk assets continued to advance in anticipation that 1) the global economy had been able to withstand higher interest rates without "breaking something" within the financial system, 2) global inflation is trending down from peak levels seen in 2021-2022, and 3) global central banks would eventually cut rates in 2024 as acknowledgment of disinflationary trends setting in.

In August, global markets had come under initial pressure from reports of further China economic deceleration. Equities and bonds issued by key property developers sold off over reports of delayed interest rate payments and stalled development programs. Ongoing property market weakness had also contributed to missed scheduled payments from income trusts sponsored by major non-bank financial companies. In the U.S., equity markets had succumbed to weaker earnings releases from the retailer sector, much of that weakness driven by increased reserves for bad debt as well as "shrinkage" (or theft); however, technology and e-commerce companies continued to benefit from the increased shift to digital-based consumption and the capital spending fueling artificial intelligence initiatives. Investor appetite for the secular, exponential growth potential of SAAS, Cloud, and AI-driven spending is expected to withstand any tightening of capital market conditions engineered by Fed rate hikes or lower liquidity through Quantitative Tightening.

Much of the U.S. economic story throughout post-COVID remains an income-driven story, first with pandemic emergency spending and then fiscal stimulus (infrastructure) that has helped contribute to both strong personal spending and labor market hiring. With late summer economic releases, there were increasing signs of labor market softness in hiring only as opposed to outright job losses. Labor market conditions appeared to be normalizing rather than correcting just as we've seen with economic data spanning spending and borrowing conditions. Indeed, labor market normalization serves as one of the lynchpins to the disinflation story. The next key item to normalize is wage growth which remains elevated versus pre-pandemic trends and can only be maintained with higher productivity.

September saw a continuation of market volatility led by a steep rise in interest rates with the 10-Year U.S. Treasury Bond reaching 5% at one point. There were unconfirmed reports of significant selling pressure and unwinding of long maturity Treasury positions from the institutional investor community. Playing defense with long duration has not followed the typical 60/40 playbook of low asset correlations between stocks and bonds over the past two years. You can thank a higher inflation regime mixed with stimulative fiscal policy in a tight labor environment for that breakdown. High interest rates, slowing nominal growth, and an uncertain earnings outlook outside of big tech spending were starting to weigh on U.S. equity valuations outside of megacap growth tech.

4th Quarter 2023: Clearing the Real Rate Path

The first two months of the fourth quarter saw continued market weakness to be followed by a strong recovery in global equities, as interest rates had reached their local peak in early October. Global equity markets gave up more ground in October although markets then rebounded from initial selling pressure following the breakout of hostilities between Israel and Hamas in Gaza in early October. Ongoing concerns over China's economy, including reports of pending defaults on offshore debt obligations by some of China's prominent property developers, and continued slowdown in industrial activity through Europe also weighed on global growth sentiment.

Following three months of weakness for both stocks and bonds, the investment landscape had been set up where the classic 60/40 equity/fixed income portfolio, largely abandoned in favor of money market funds and hedged equities, had become the new maximum pain trade. Many investors only want to hold cash yielding 5% as opposed to locking in longer-term rates due to higher sensitivity to rate volatility, and investors were increasingly hiding out in the mega-cap technology stocks as valuations between large cap growth and value have only widened this year and approaching peak valuation gaps seen in 2020-2021.

Global equities saw a sharp recovery in November, with a broadening of performance across YTD laggards such as small caps. November saw a return of investor optimism over the disinflation slowdown with several Fed governors, notably by Christopher Waller, observing that higher real (inflation-adjusted) interest rates were having a tightening effect on the economy and financial conditions. Higher rates appear to be slowing down inflation at a pace the Fed is comfortable with such that further rate hikes may not be warranted. Both global equities and fixed income rallied over prospects that we may be approaching an end to central bank tightening with easing expected in early 2024.

As the 3rd quarter earnings season wrapped up, several industrial and consumer discretionary companies sounded cautious or warned on forward guidance, but overall earnings estimates continued to climb higher, boosted by increased technology spending (cloud, digital, servers, artificial intelligence).

As we head into 2024 with consumer spending still quite strong, even if with signs of a post-COVID slowdown, the economic environment appears to be shifting towards an Immaculate Slowdown, a corollary that sees a meaningful deceleration of economic activity (spending, investing, inventories) without resulting in a recession/layoffs. Equity valuations (earnings multiples) expanded and real interest rates dropped producing an immaculate environment of strong positive performance across both risk-on and risk-off asset classes (the exception being commodities dragged down by a drop in energy prices). The economic soft-landing scenario that many had doubted earlier in the year has increasingly becoming the base case outlook for 2024, at least through the 2024 election.

Yet, nearly $\frac{3}{4}$ of stocks in the S&P 500 have underperformed the index in 2023 according to Apollo Global Management, encapsulating the narrowness of this year's market advance. The Magnificent 7 are up more than 20 times as much as the remaining 493 in 2023 and the top 10 stocks in the S&P 500 now account for 35% of the entire index. The worst of the post-COVID surge in inflationary pressures seem to be behind us, and financial assets have discounted the rearview as well as the optimism over U.S. earnings growth and profitability. Institutional investor crowding in the Magnificent 7 have reached historical levels of concentration while the prospective returns of the top mega-cap names remain market-level at best. The traditional 60/40 portfolio is re-emerging as the favored strategy for positioning into 2024, but with a smaller margin of error should Immaculate Slowdown prove to be anything but.

December 2023 Market Review

Global equity markets rose in December, continuing their strong year-end recovery from the early Autumn losses, as the bond market enjoyed lower rates on expectations of 6-7 Fed rate cuts in 2024, as opposed to just 3 implied by the Fed's dot-plot projection. The U.S. dollar's weakness also accelerated over expectations of U.S. monetary easing and improving economic conditions across the rest of the world, particularly Europe. The MSCI All-Country World Index (ACWI) returned +4.8% for the month of December.

Across major regions (Figure 17), European and U.S. equities continue to outperform Asian and Emerging Markets. MSCI Europe returned +5.0% and the S&P 500 returned 4.5%, outperforming MSCI Pacific ex Japan (+4.6%), MSCI Japan (+4.4%) and MSCI Emerging Markets (+3.9%). The U.S. dollar (Figure 18) weakened in December, reflecting a convergence in forward monetary expectations versus the other developed markets.

Figure 17 – Europe and the U.S. Outperformed Asia Developed and Emerging Markets

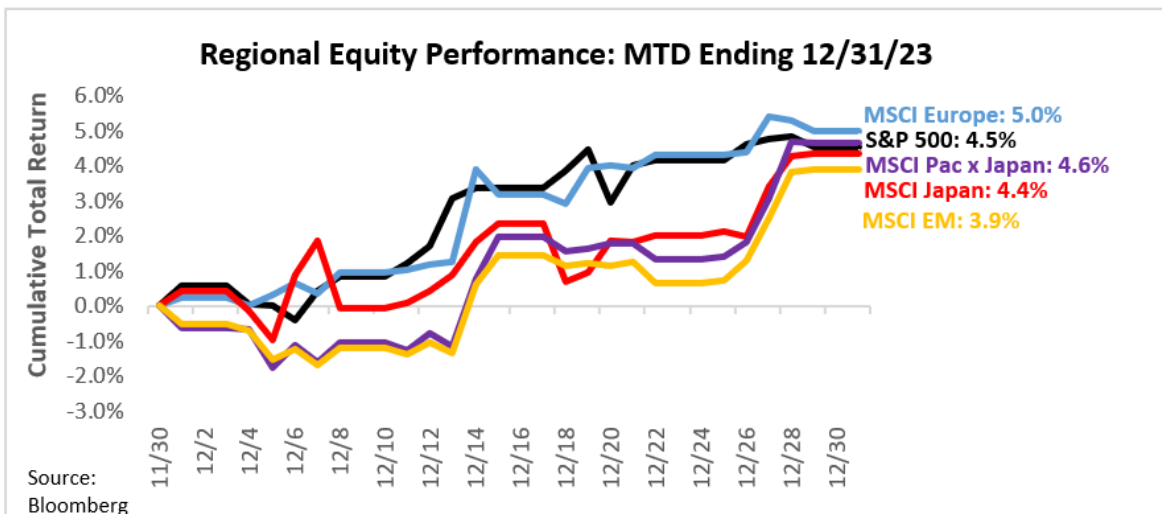
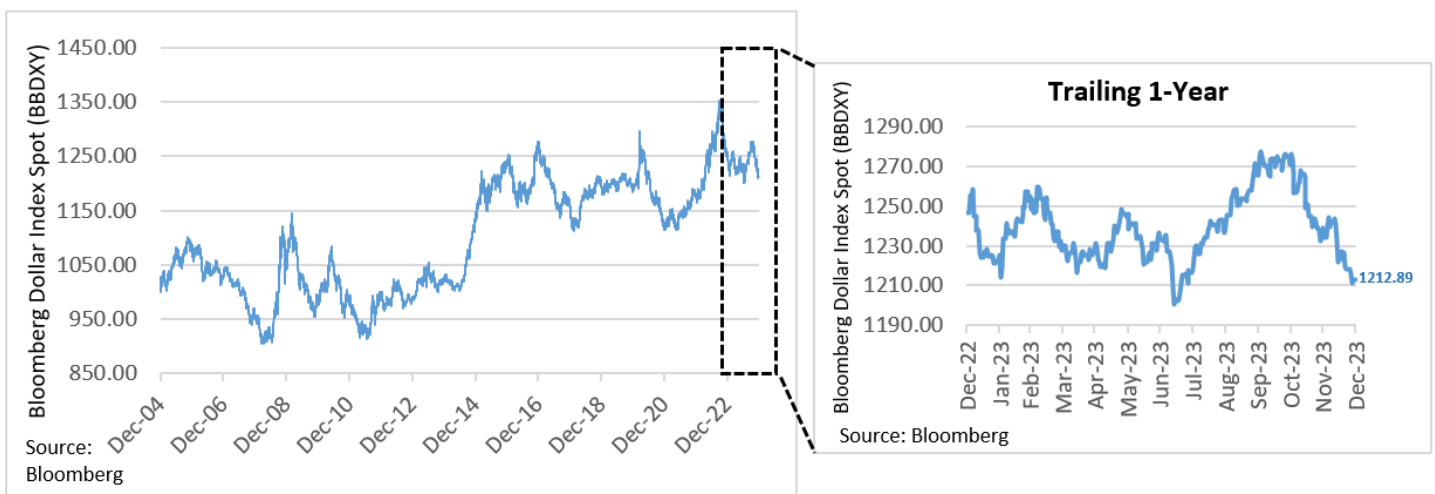
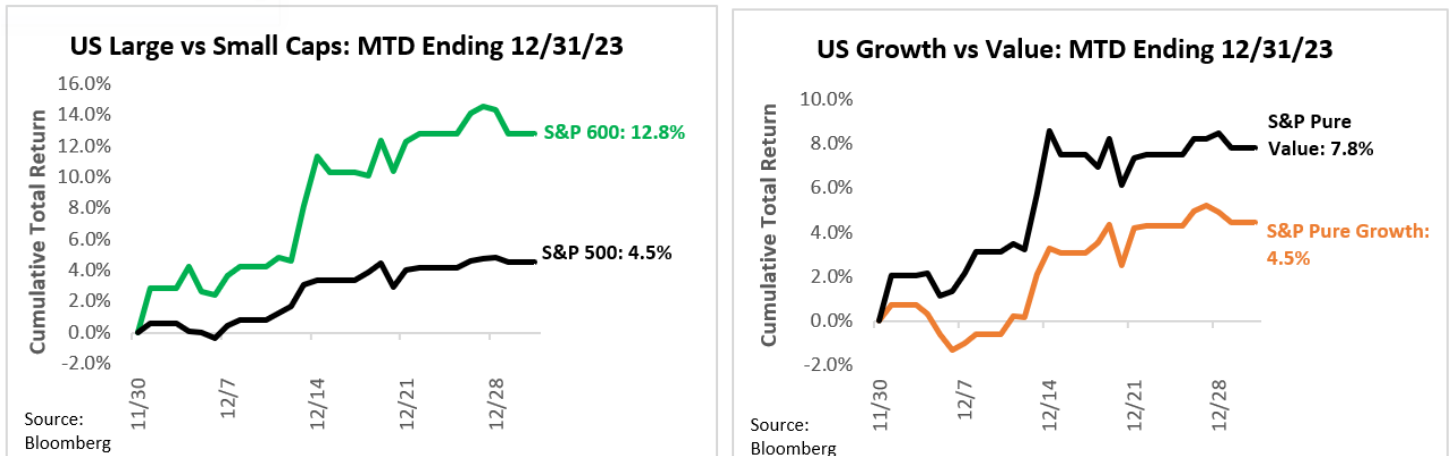


Figure 18 – The U.S. Dollar Weakened Over Expectations of Deeper Fed Easing



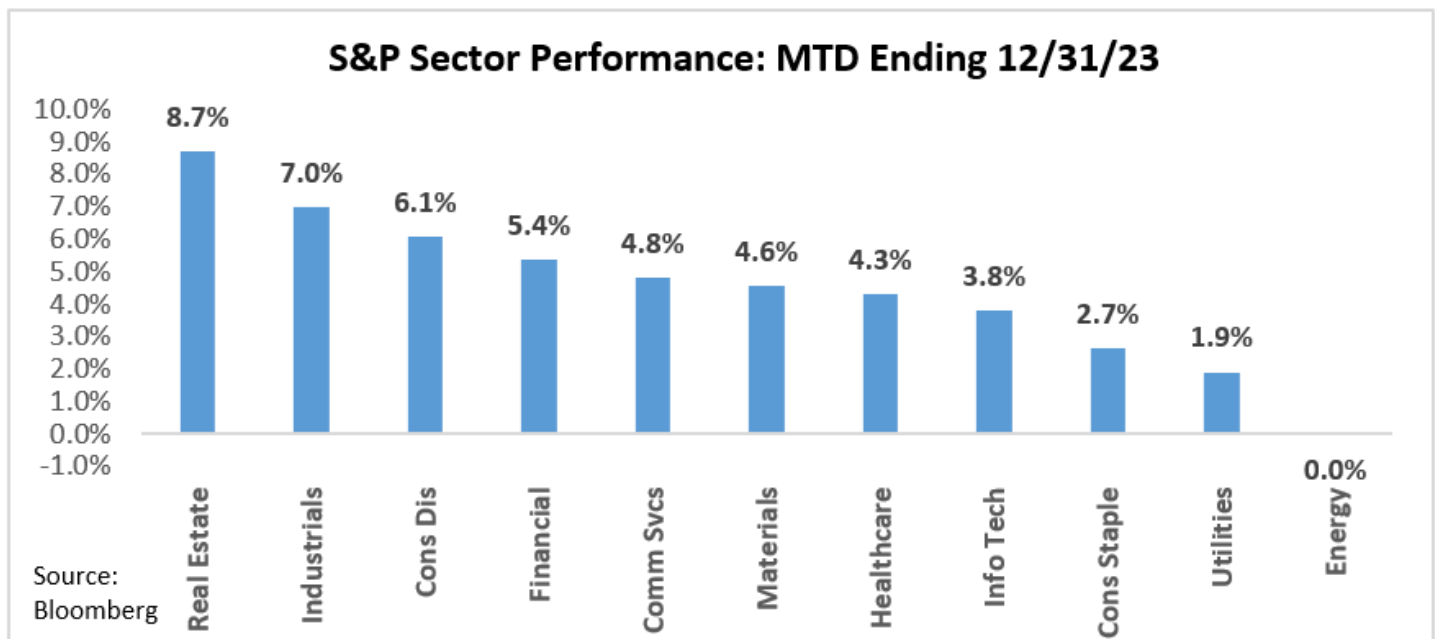
Within the U.S., small caps outperformed large caps as small caps benefited from the risk-on optimism over deeper Fed rate cuts and slowing inflation. S&P Pure Value outperformed Pure Growth, with the former helped by a recovery in interest-sensitive financials and beaten down consumer cyclicals, although both styles benefited from the broadening out of market breadth. For the month of December (Figure 19), the S&P 600 Index returned +12.8% versus +4.5% for the S&P 500. S&P Pure Value outperformed Pure Growth, returning +7.8% and +4.5%, respectively.

Figure 19 – Small Caps Outperformed Large Caps and Value Outperformed Growth



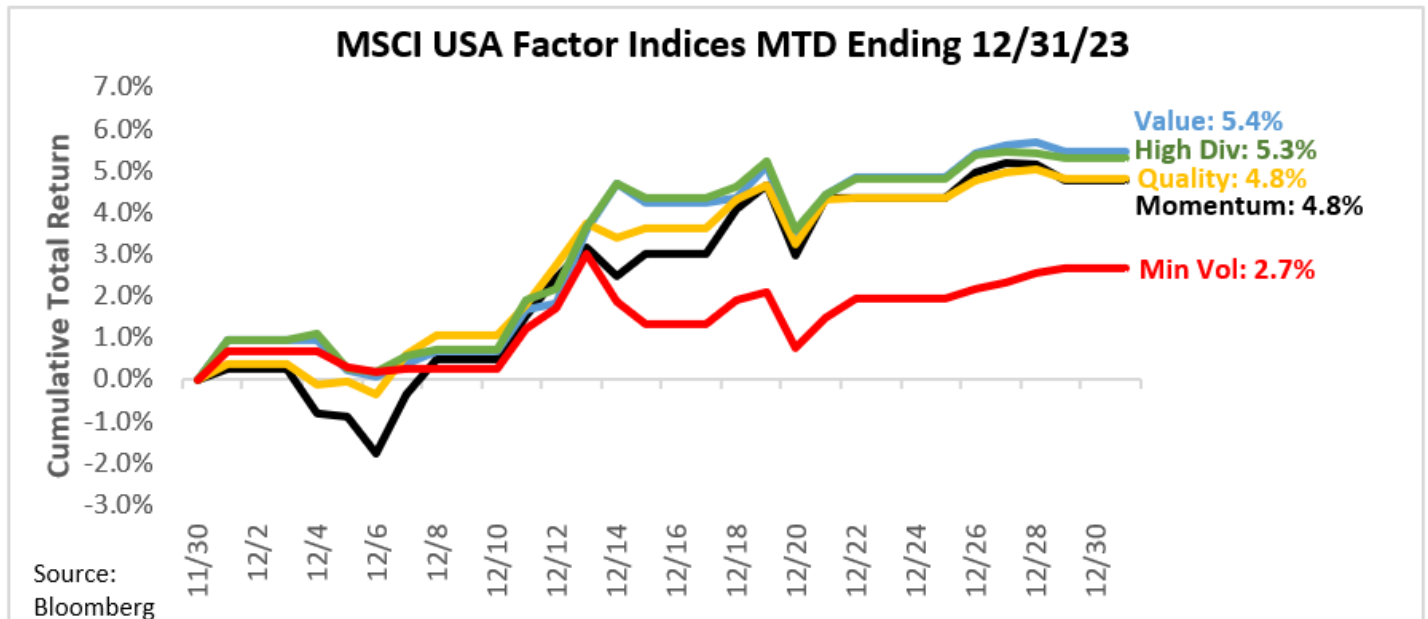
Across sectors (Figure 20), real estate and traditional cyclicals outperformed defensive sectors (Healthcare, Utilities, Staples), while Energy was hurt by lower commodity prices.

Figure 20 – Traditional Cyclicals and Real Estate Outperformed Defensive Sectors



In December (**Figure 21**), most risk factors outperformed the broader market, led by Value and High Dividend. Minimum volatility underperformed as higher risk segments of the market outperformed.

Figure 21 – Value and High Dividend Factors Outperformed in December



Fixed Income markets rallied following a sharp drop in interest rates and narrowing credit spreads. U.S. Treasury yields dropped in anticipation of a slowing economy and government spending as well as expectations of central bank easing throughout 2024. The Bloomberg U.S. Aggregate Bond Index returned +4.5% for the month (**Figure 22**), as the 10-Year Treasury yield dropped to 3.8% from the 5% peak level seen in early October. Corporate bonds continue to outperform as borrowing spreads (**Figure 23**) narrowed further with bond investors presuming an environment of lower rates but not recessionary conditions that would pressure corporate balance sheets. The Global ex-U.S. Aggregate Index returned +3.8%, outperforming the U.S. Agg, reflecting U.S. dollar weakness. Bloomberg Emerging Market Local Currency also outperformed U.S. fixed income, returning +4.1% for the month, while Bloomberg US High Yield continued its strong YTD performance, returning +3.7% for the month, as credit spread compression helped offset the lower maturity profile of high yield debt.

The 10-Year U.S. Treasury yield ended the month at 3.8%, down from 4.3% at the beginning of the month. The 2-10 Year Term structure (**Figure 24**) steepened throughout December while inflation expectations implied by breakeven rates between TIPS vs Nominal Treasury yields dropped from late Autumn peak levels, suggesting that the U.S. may be moving towards the long-term 2% inflation level. Global bond yields also dropped from earlier peak levels (**Figure 25**).

Figure 22 – Fixed Income Rallied with this Month’s Drop in Interest Rates

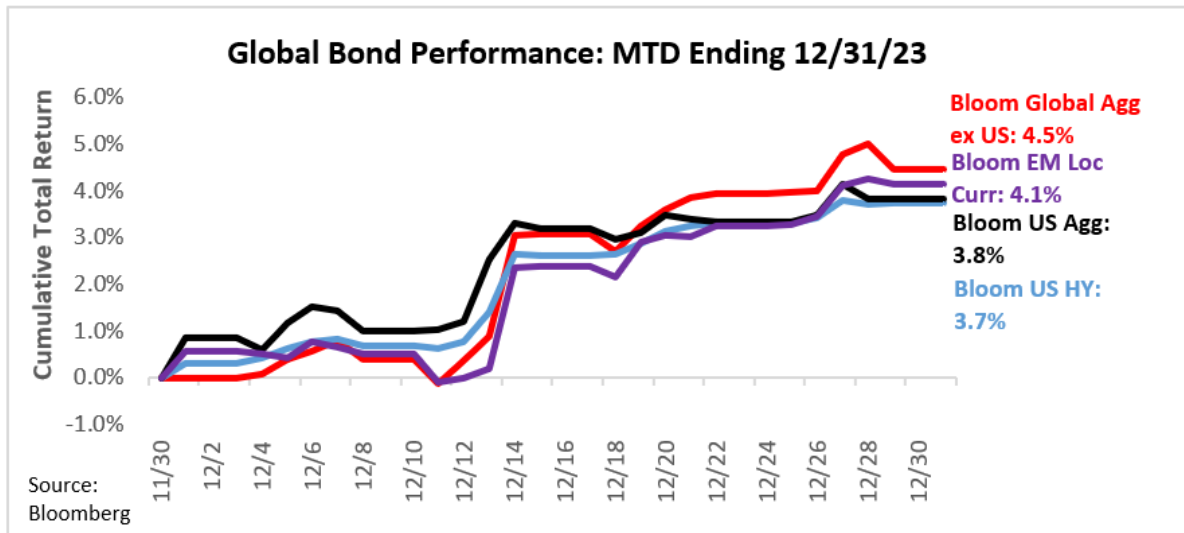


Figure 23 – Corporate Borrowing Spreads Narrowed Sharply in December

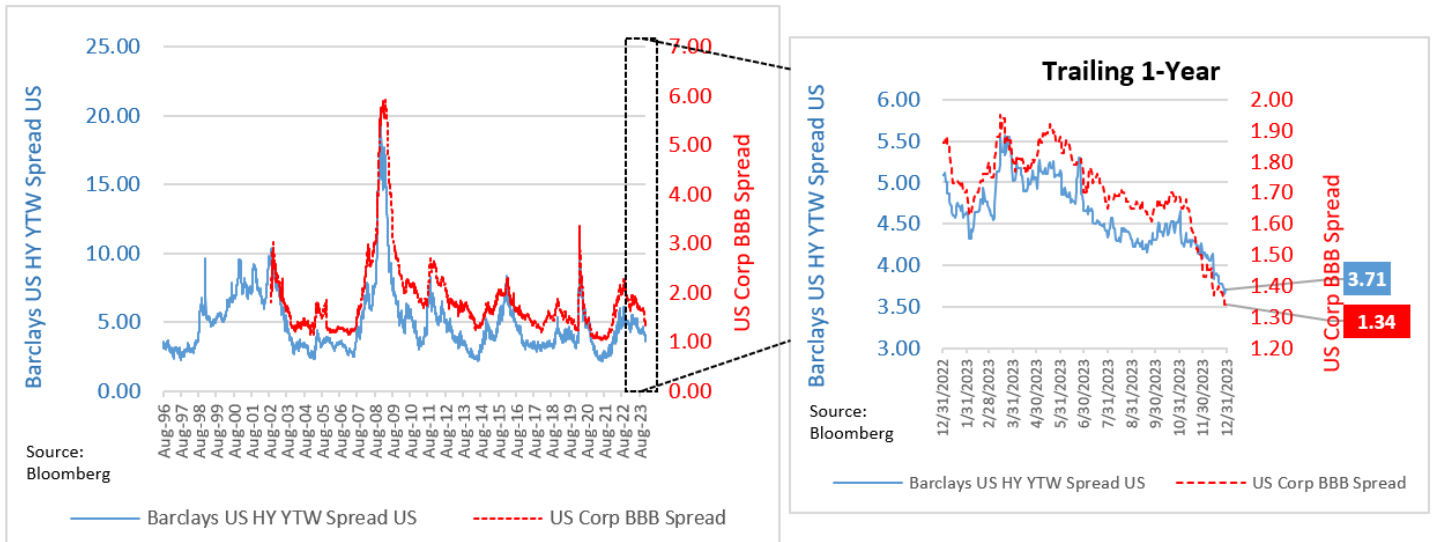


Figure 24 – 2-10 Year Term Structure Steepened While Inflation Breakeven Rates Dropped Further

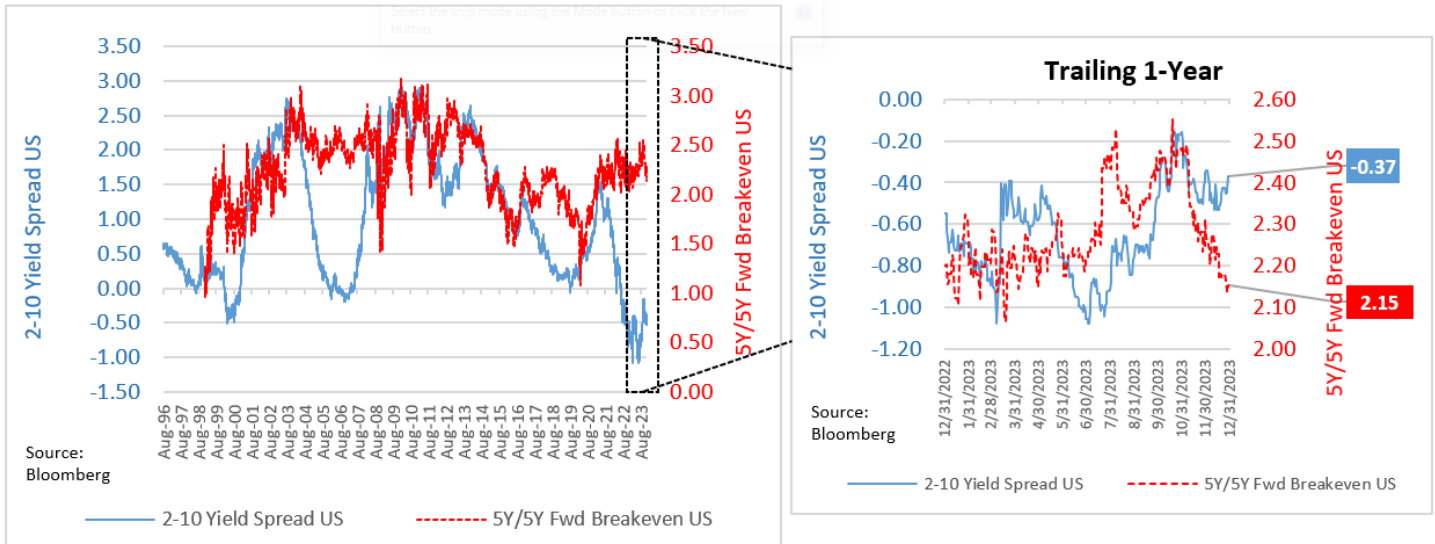
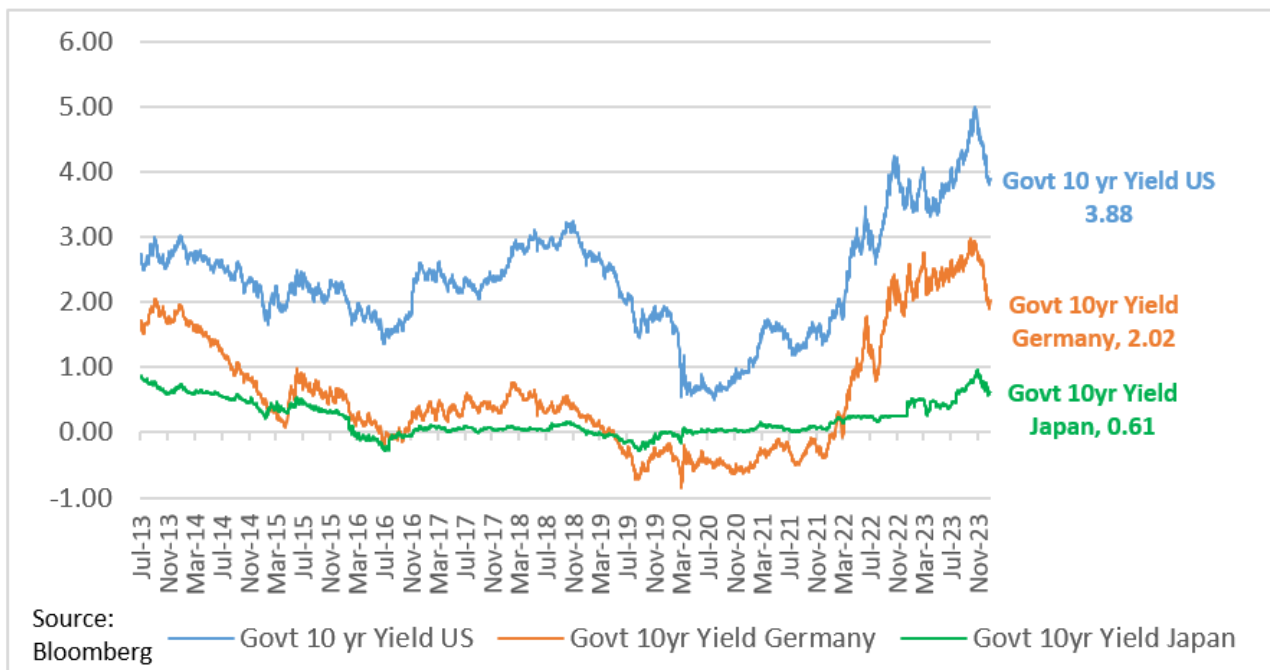
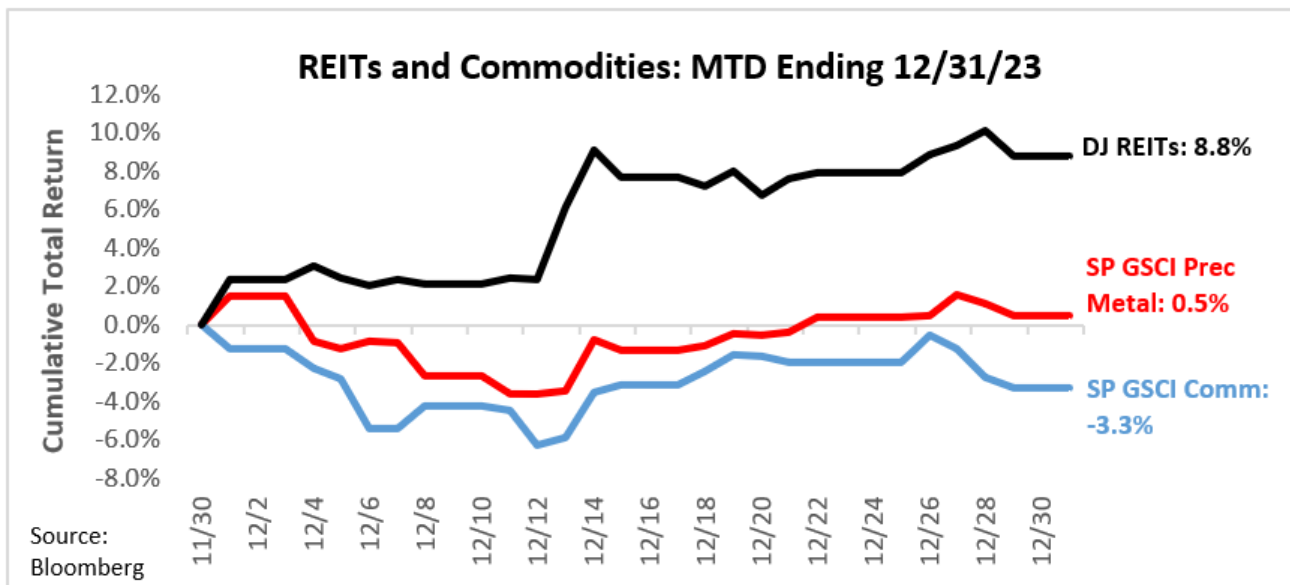


Figure 25 – Key Sovereign Bond Yields Have Dropped from Their Late Autumn Peak Levels

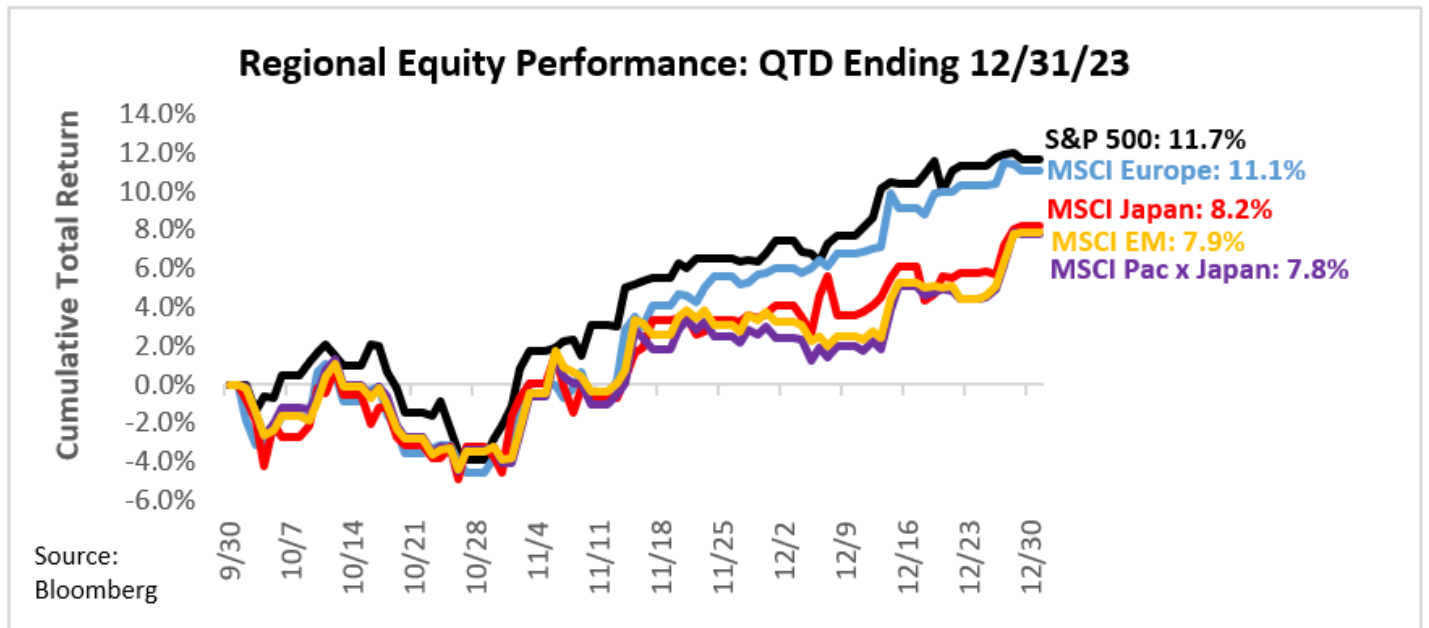
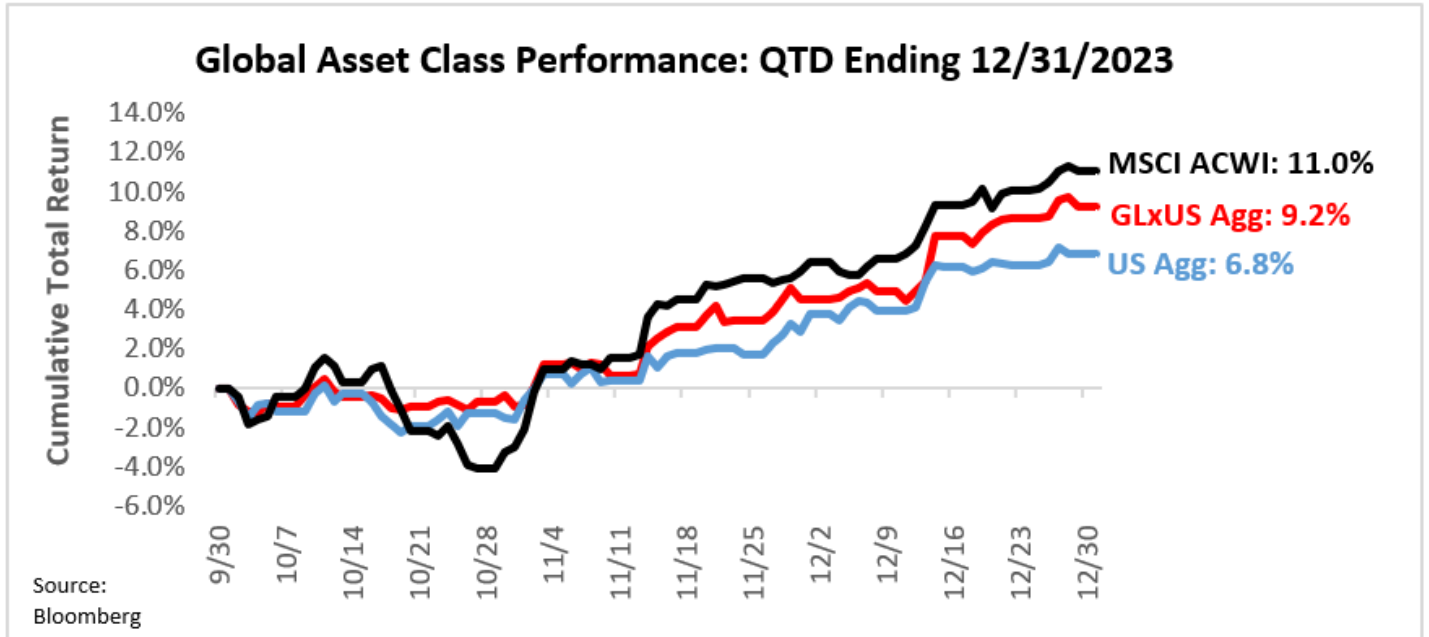


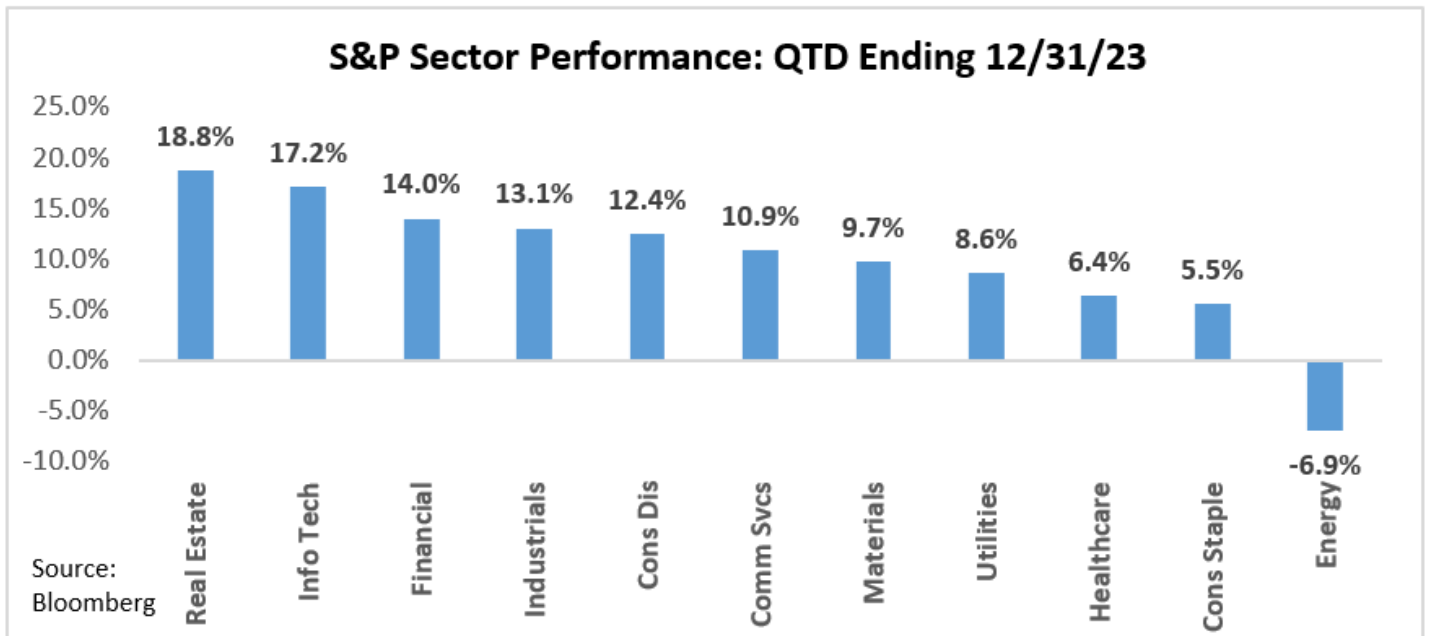
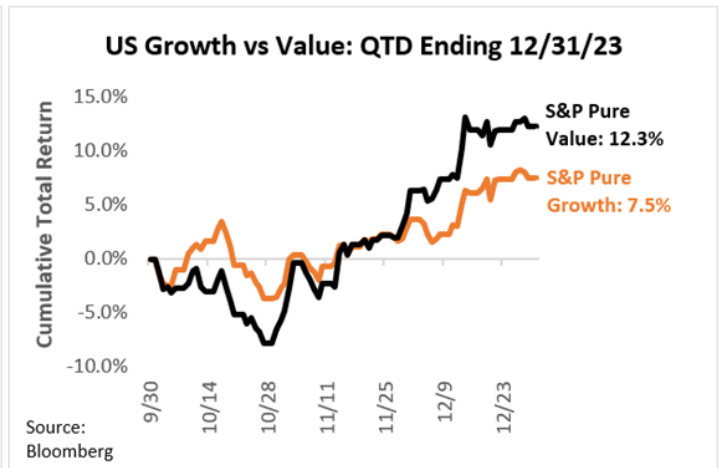
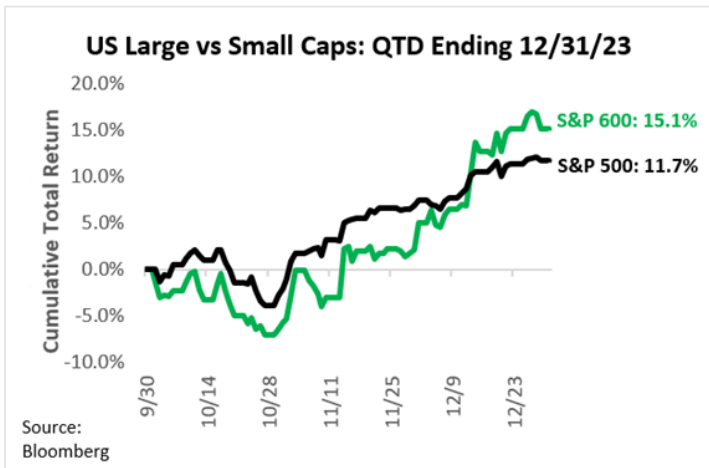
Within equity alternatives (**Figure 26**), Real Estate continued its strong run from November, benefiting from the drop in interest rates and relief from expected Fed easing in 2024. Gold prices also remained firm, with spot prices settling above \$2000/ounce. Commodities were hurt by lower energy and agricultural prices, even though industrial metals, especially iron ore, turned higher. In December, the Dow Jones REIT Index returned +8.8% and the S&P GSCI Precious Metals Index returned +0.5%. The S&P GSCI Commodities Index returned -3.3% hurt by lower energy prices.

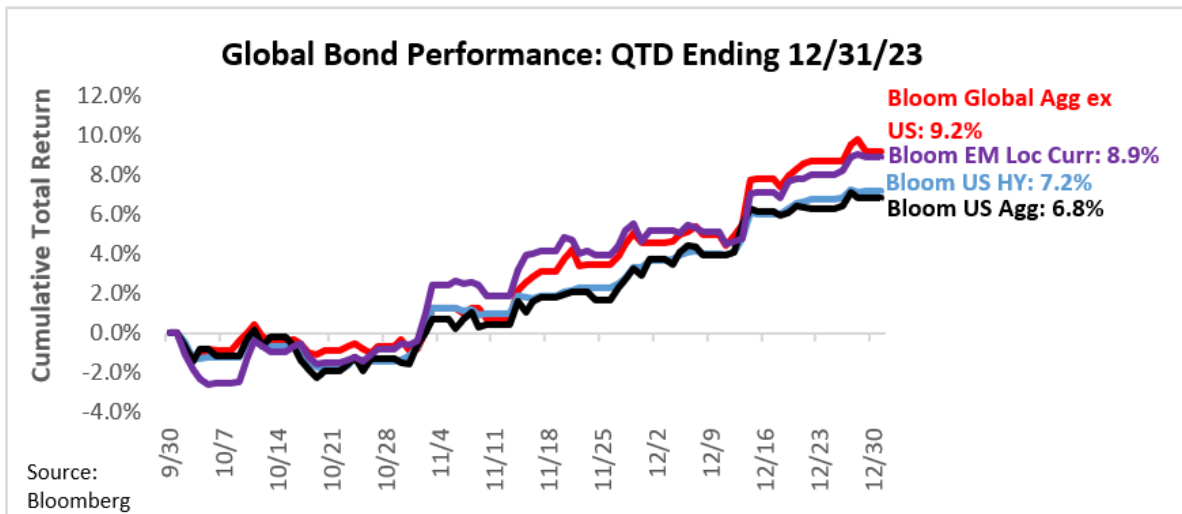
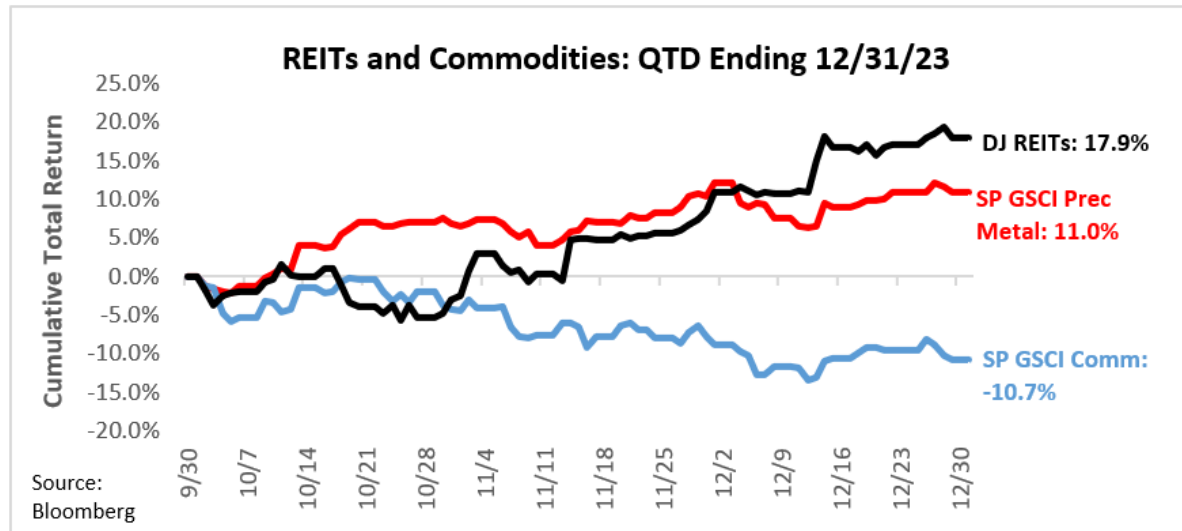
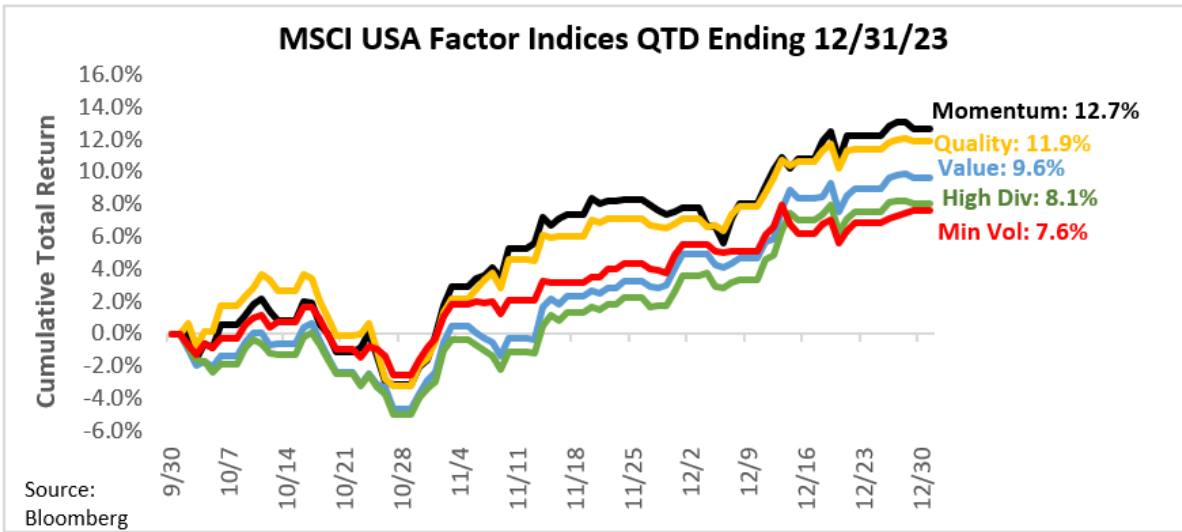
Figure 26 – In December, Real Estate Recovered Sharply Benefiting from Prospects of Easier Fed Policy in 2024 while Precious Metals Rallied as Spot Gold Rose Above \$2000/Oz



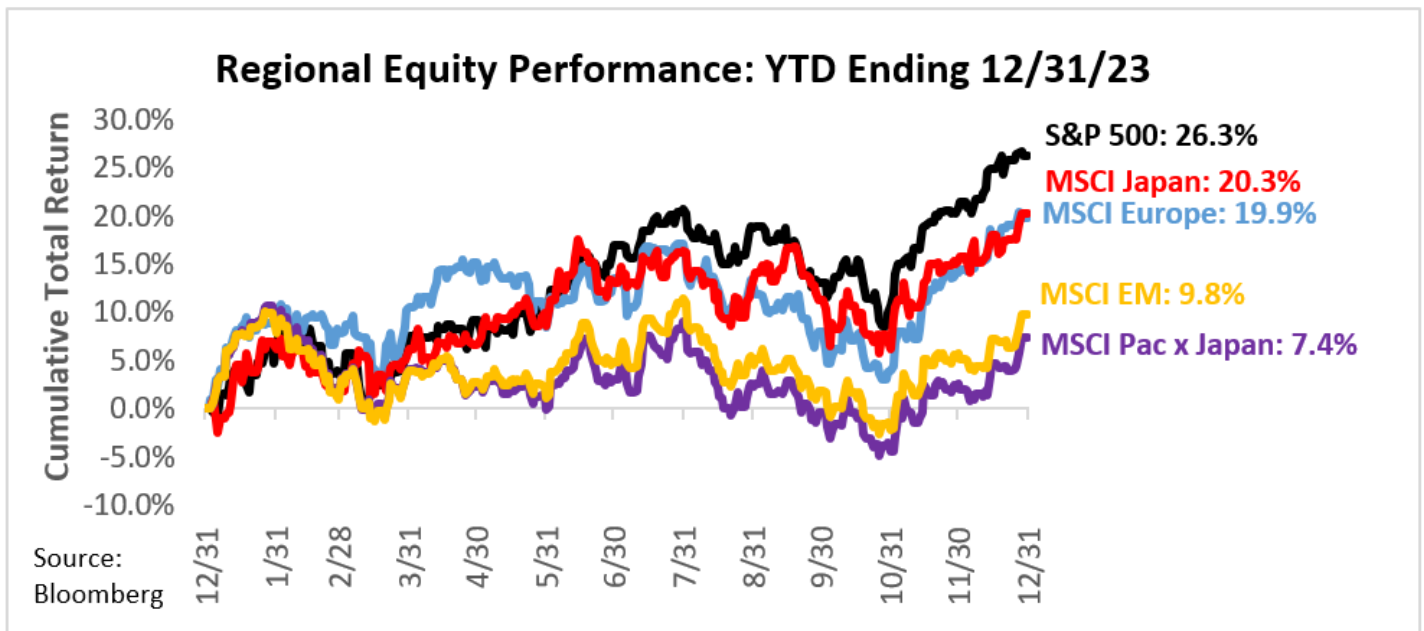
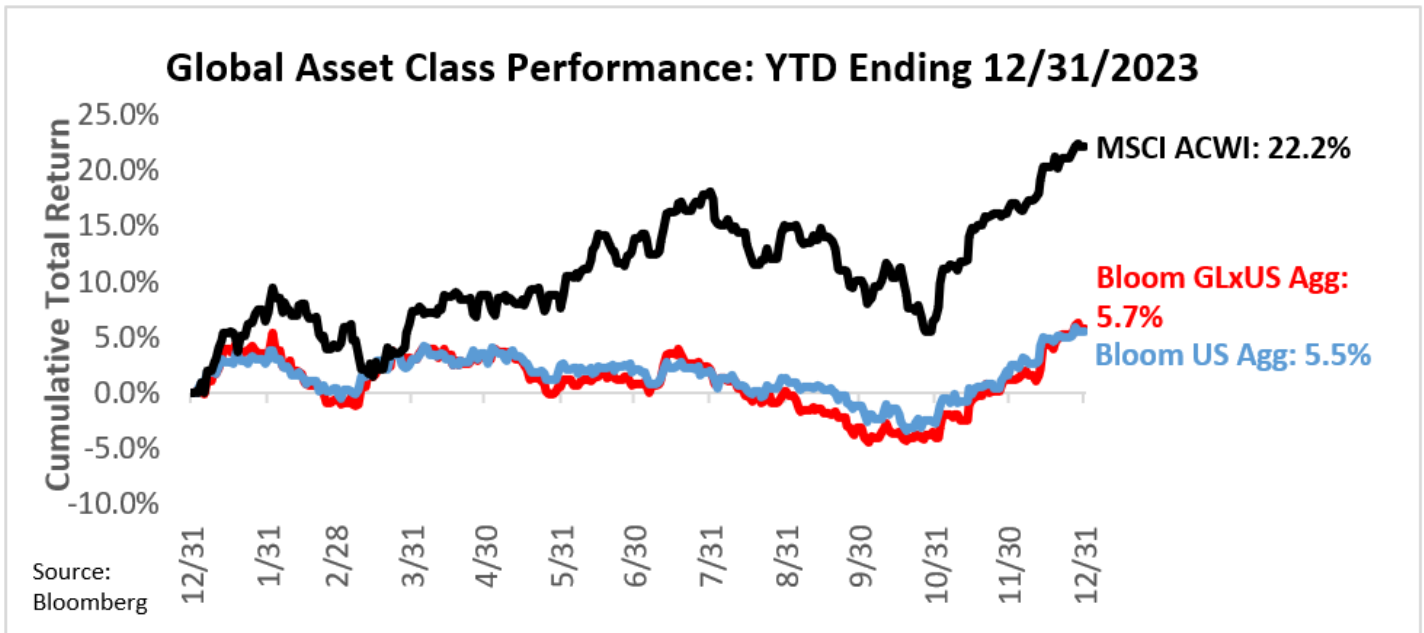
4th Quarter 2023 Performance Charts

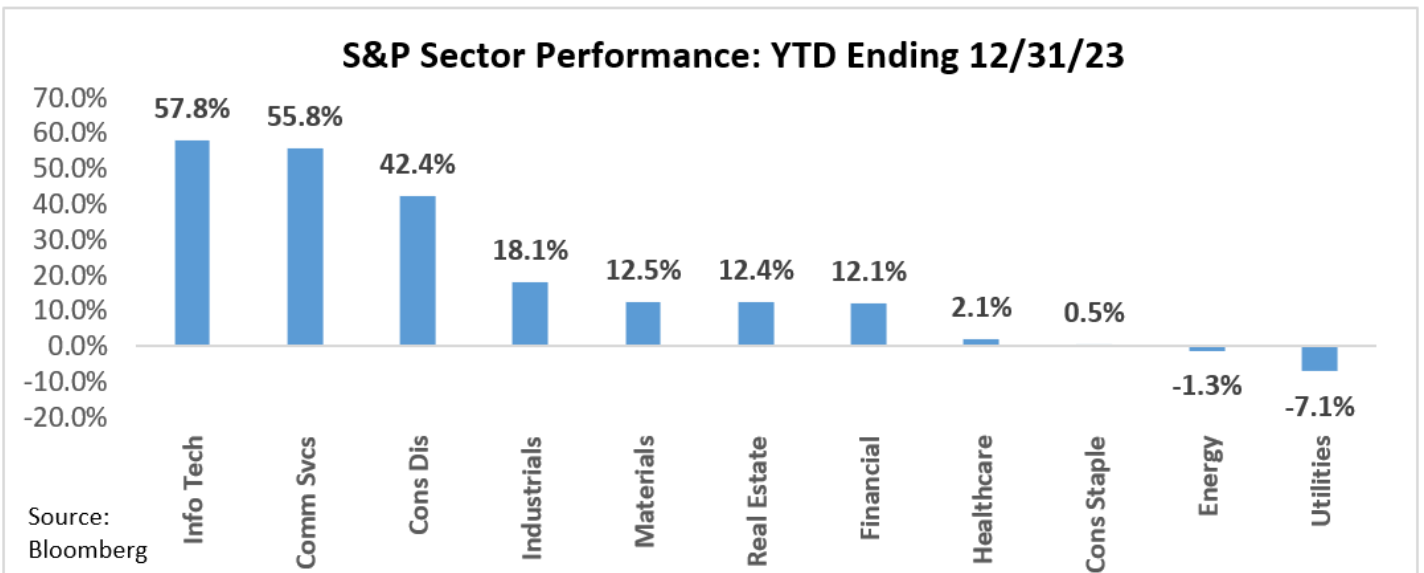
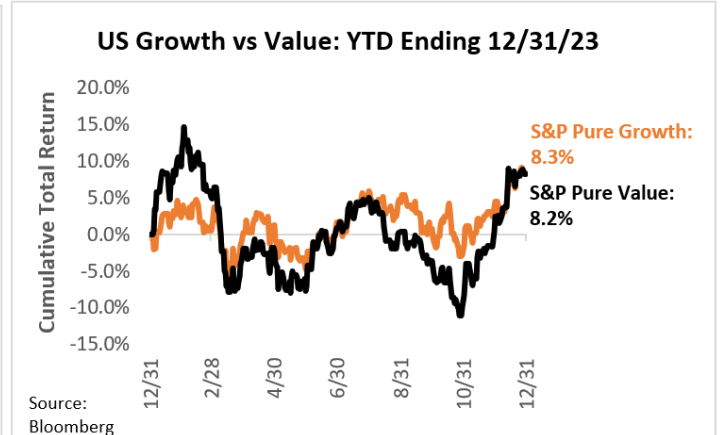
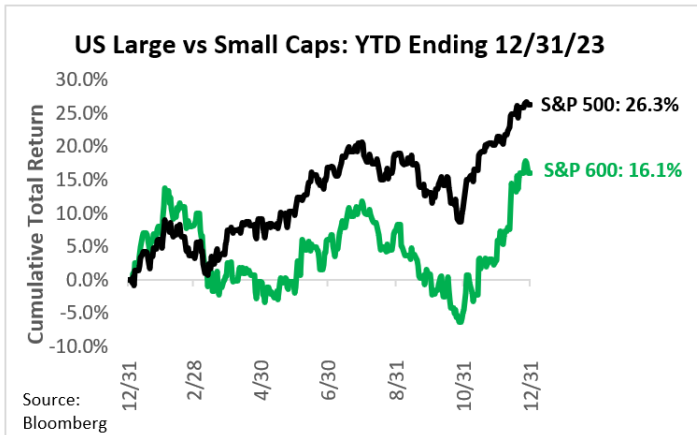


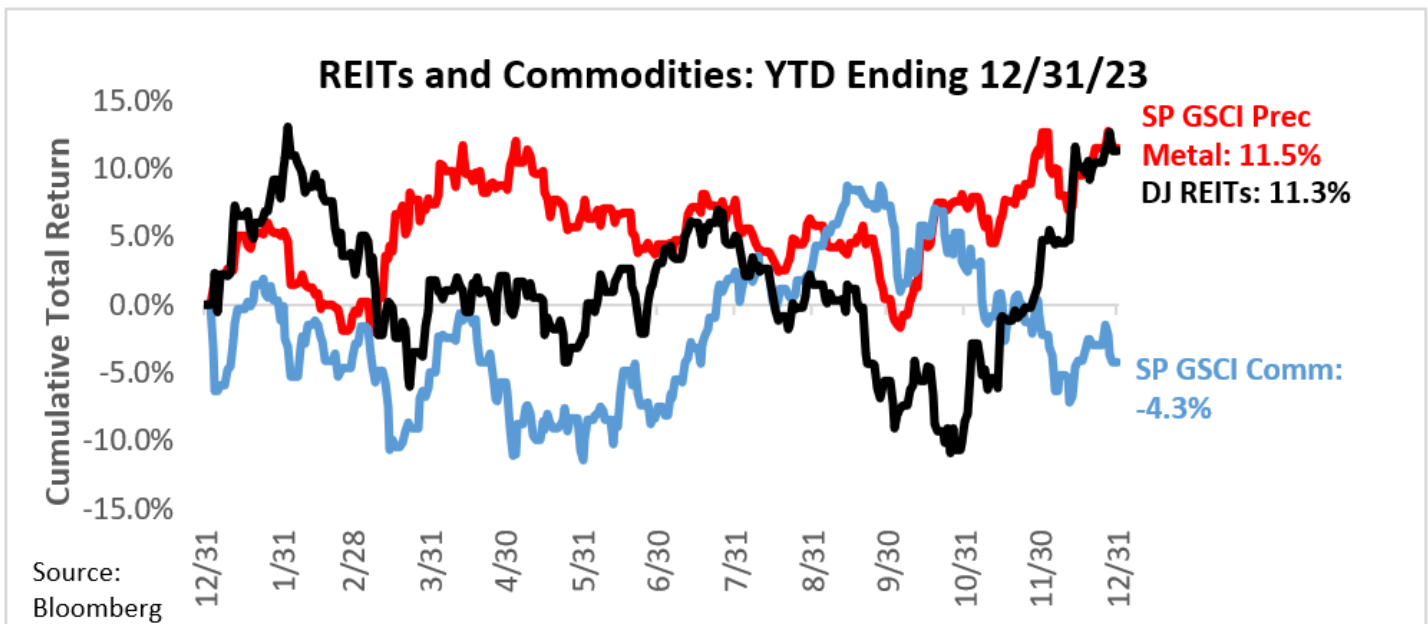
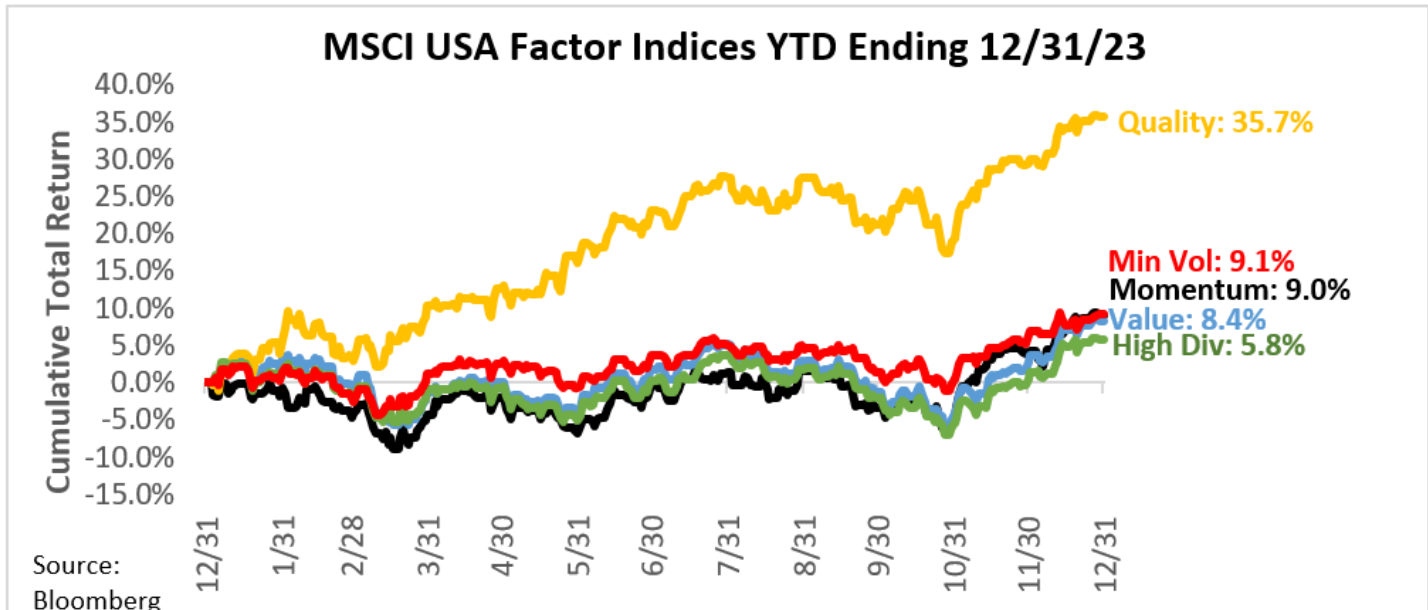


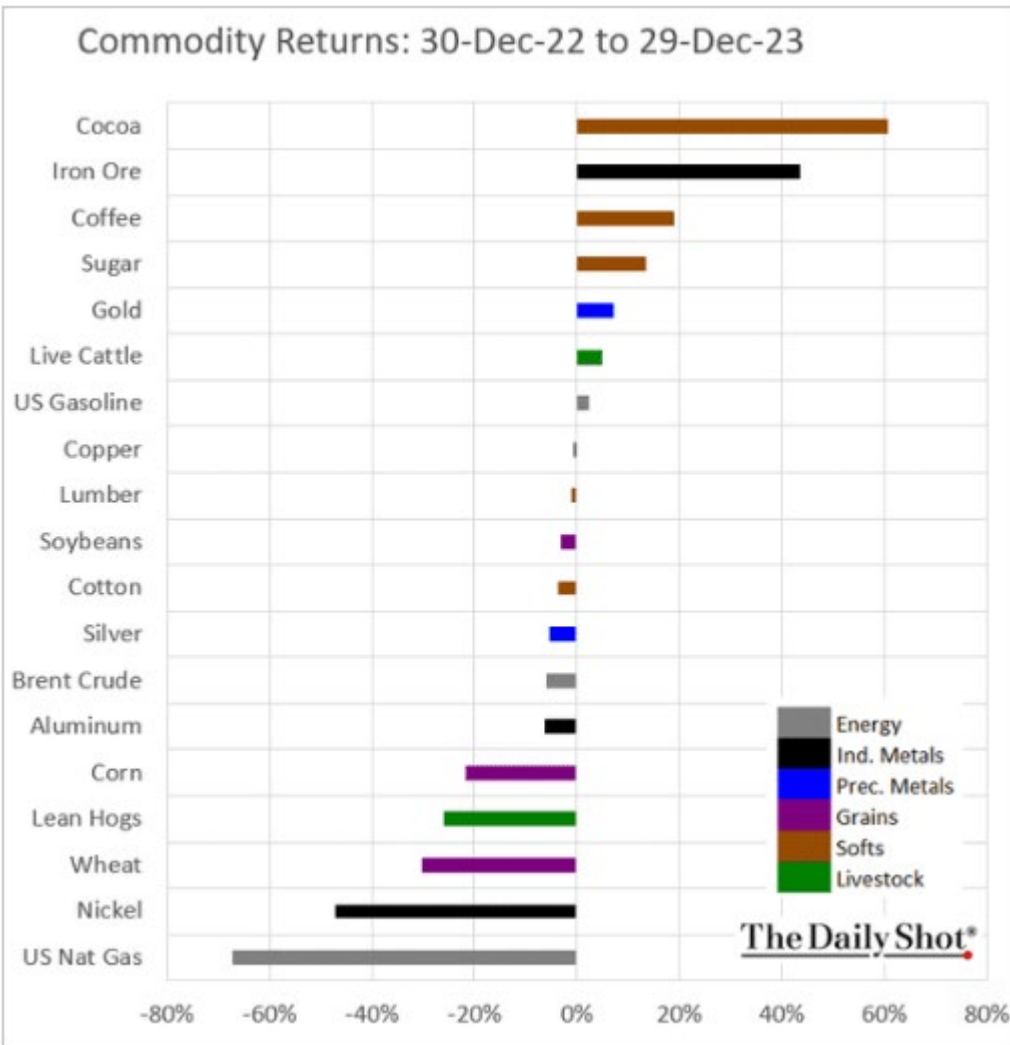
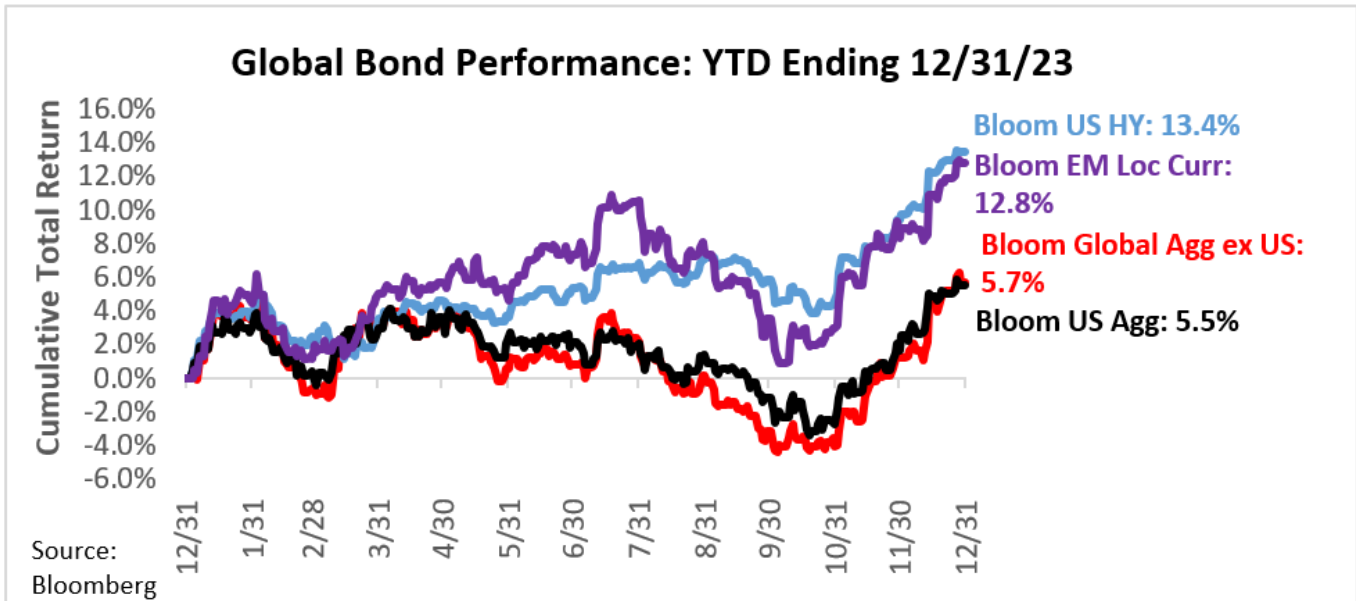


Full Year 2023 Performance Charts

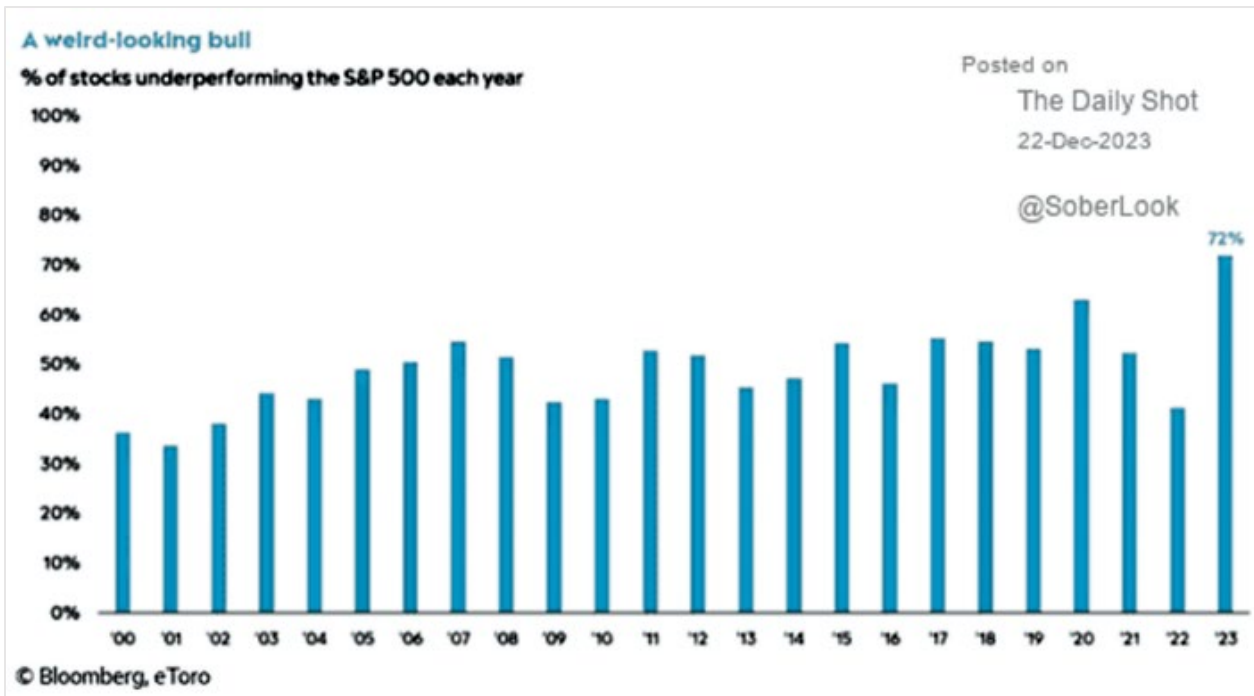
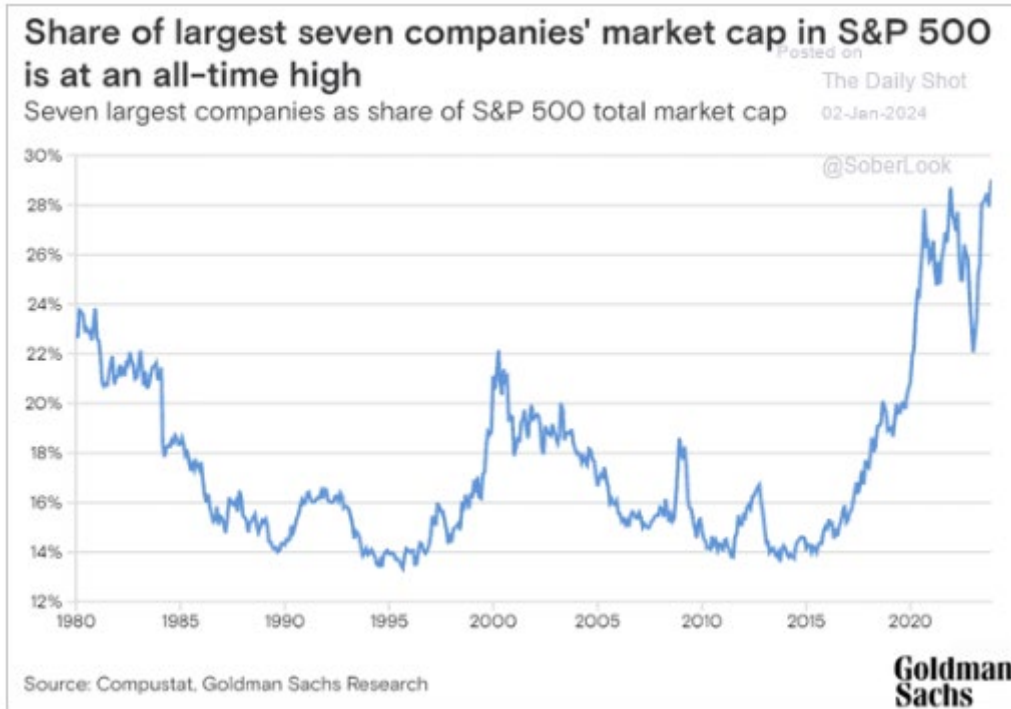








2023 Notable Charts



Value Stocks Are Still Cheap Relative to History Global value shares' valuation spreads remain wide against growth

■ MSCI World Growth Index 12-month forward P/E ratio - MSCI World Value Index



Source: Bloomberg

Bloomberg

The CARRY (cross-asset risk and relative yield) landscape

Annual income (%)



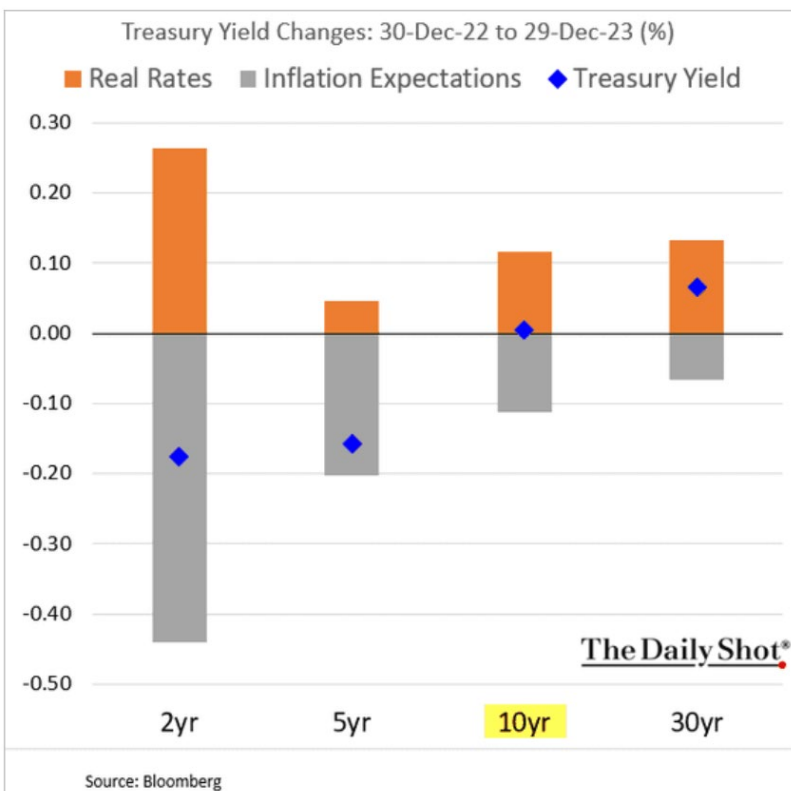
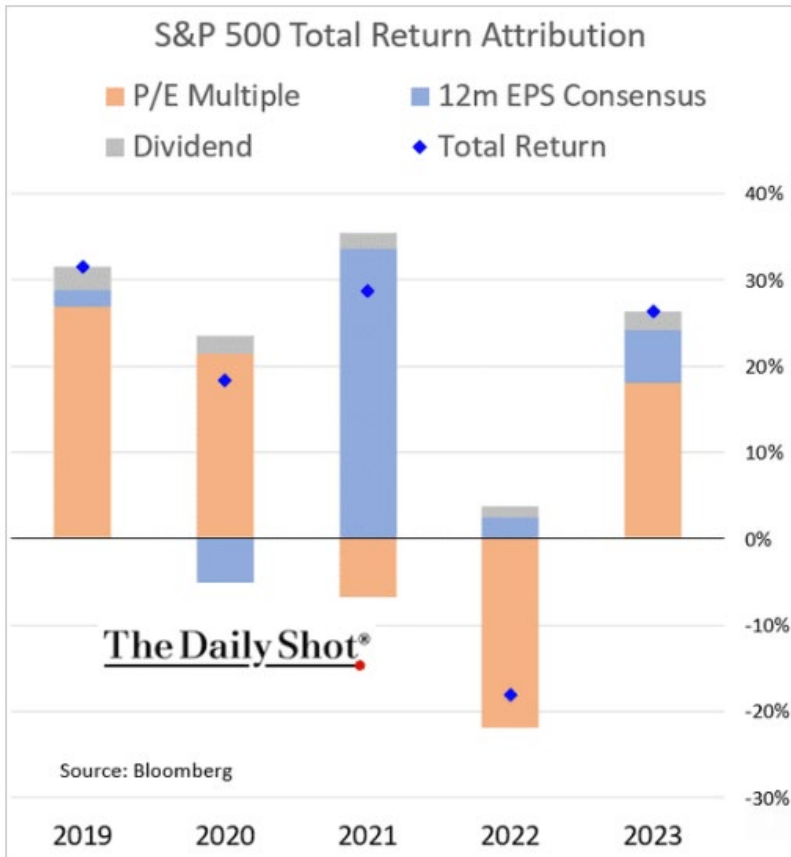
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The Daily Shot
October 2024
@SoberLook

Asset	Low	Medium	High
Key risk	100% index	50% index	20% index
Equity Concentration	1 - 5y	5 - 10y	10y+
DM govt bonds Duration	AAA - BBB	BB	B - CCC
Credit Credit risk			

Sources: Wellington Management, Refinitiv, Factset, Cliffwater. Data as at 31 October 2023. Private credit data as at 30 September 2023. Private credit data reprinted by permission of Bank of American Corporation (BAC). See additional disclosure at end of the article. Global equity data provided by Factset. For illustrative purposes only. PAST RESULTS ARE NOT NECESSARILY INDICATIVE OF FUTURE RESULTS.

Clearing the Real Rate Path

Year-End 2023 Market Commentary and 2024 Outlook





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