Executive Summary **January 2024**

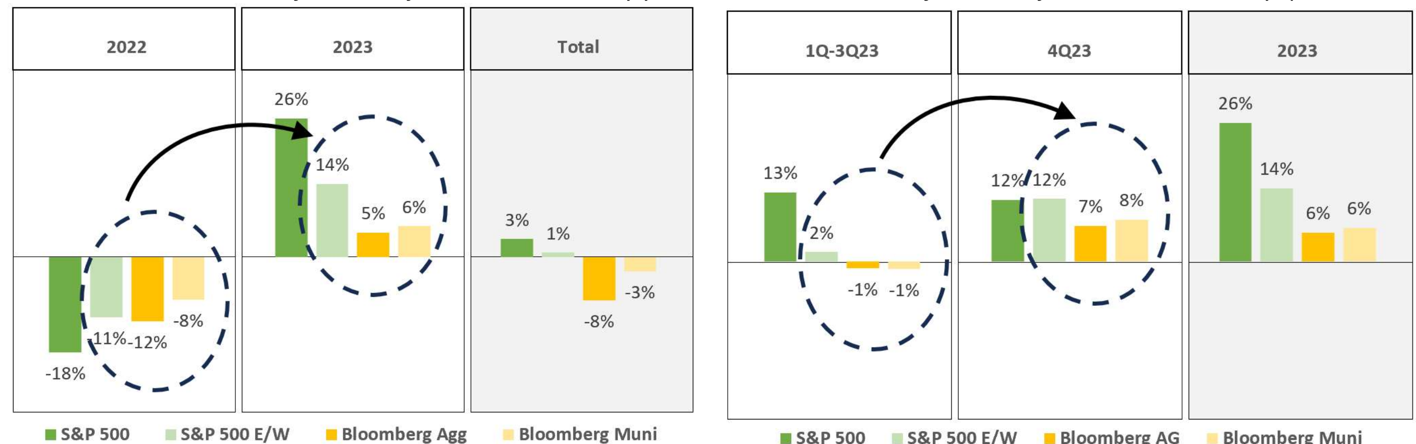
Dear clients and friends,

Markets were strong in 2023, recapturing most, if not all, of the value lost in 2022; this is highlighted in **Exhibit 1**. This occurred despite consensus concerns for a looming recession, with "*the 2023 bull market few expected"* representing a recent reminder of why *time in markets*, and not *timing of markets*, drives an investor's long-term financial success. The broad-based strength for the 2023 calendar year differs from the state of the markets through the third quarter, when performance was concentrated in a handful of large-cap tech stocks (*the Magnificent 7)*, with the average stock (*S&P 500 E/W*) and major bond indices (*Bloomberg Agg* and *Muni*) roughly breakeven. So, for most of the financial markets, positive calendar year returns were primarily generated in the fourth quarter, where we saw broad participation across equity style (*value* and *growth*) and size categories (*large, mid* and *small*) and strong breadth in fixed-income, with strong returns across bond types supported by dropping rates across the maturity curve and tightening credit spreads.

Broad-based fourth quarter returns were aided by moderating inflation and a surprisingly resilient economy, which drove the Fed to lower the Fed Funds Rate target and has increased the probability of a *soft landing*, in which inflation will reach the Fed target and the economy will avoid a recession. Still, with valuations pricing in a higher likelihood of a soft landing, we enter 2024 with added downside risk if one not occur. The US election and tensions abroad add to the range of market outcomes. So, while markets exited 2023 on strength, the future remains uncertain, and we continue to manage portfolios to be resilient to a wide range of scenarios. For 2024, we are focused on the pace and extent of Fed rate cuts, the resilience of the economy, and their market implications, and will manage portfolios accordingly.

Exhibit 1: Financial markets were strong, with the 2023 bull market recapturing most (if not all) of the value lost in the 2022 bear market. For most of the financial markets, that strength came during the fourth quarter

2022 & 2023 total returns for the major market indices, by year *2023 total returns for the major market indicies, by quarter*



Source: United Asset Strategies, Bloomberg Financial

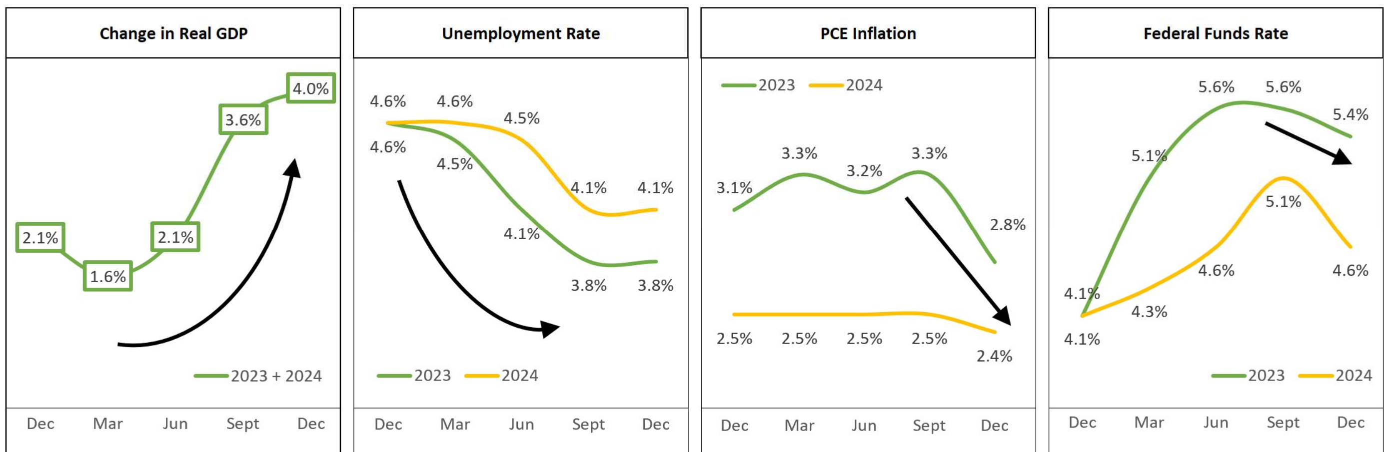
Macro & Market Recap

Markets increasingly price in a soft landing. As mentioned in our last letter, inflation continues to moderate despite the economy exceeding expectations for much of 2023. **Exhibit 2** highlights how that macro strength drove the Fed to positively revise its projections for GDP growth and unemployment, leading to a dovish Fed pivot in the December meeting, where it lowered forecasts for inflation and the Fed Funds rate. As per its Summary of Economic Projections (SEP), the Fed expects 5.4% and 4.6% Fed Funds rates for 2023 and 2024 (compared to 5.6% and 5.1% in the September 2023 meeting). It also guides to a healthy economy through 2026, with a stable labor market and declining inflation and Fed Funds rates.

Rather than lower the Fed Funds Rate to accommodate a struggling economy and labor force, the Fed is doing so alongside moderating inflation to ensure that real interest rates (the difference between interest rates and inflation), do not become overly restrictive to the economy. This soft-landing scenario is positive for markets given implications for healthy corporate profits and valuation support and drove the strong fourth quarter market performance previously discussed. Markets tend to lead the economy and sniffed out the growing possibility of a soft landing in mid-October, with the 10-year Treasury yield retreating from a peak near 5% to close the year just below 4% and financial markets beginning a broad-based rally.

Exhibit 2: Persistent economic strength and moderating inflation drove the Fed to alter its macro expectations throughout the year, eventually leading to a dovish Fed pivot in its December meeting.

Federal Open Market Committee (FOMC) - Summary of Economic Projections (SEP)



Source: United Asset Strategies, Board of Governors of the Federal Reserve System

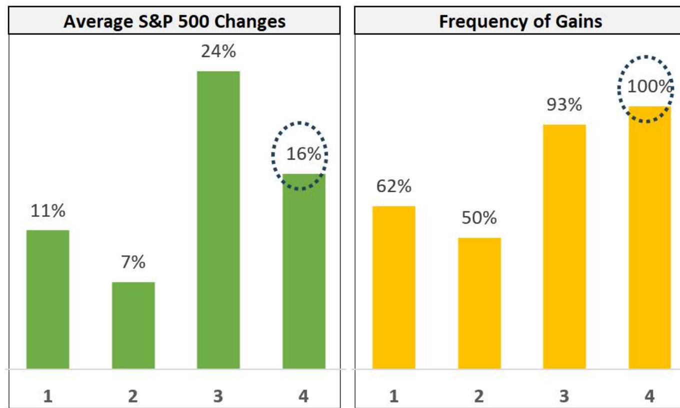
Macro & Geopolitical Outlook

A soft-landing is not a forgone conclusion. While a resilient economy and moderating inflation have increased the probability of a soft-landing, it is still not a forgone conclusion. The US Coincident Economic Index (CEI), which tracks the current state of the economy, increased an annualized 2%, confirming the recent macro strength. Still, the US Leading Economic Index (LEI), which tends to lead the economy by seven months or so, contracted by -6%, which meets the Conference Board's recession signal. So, while the CEI is strong, the LEI points to macro headwinds ahead, with the board forecasting negative GDP growth in the second and third quarters of 2024 and a recovery later in the year. Further, while inflation has moderated, there is risk that easing monetary policy will reignite inflation concerns. One example is the housing market, which makes up a third of the Consumer Price Index (CPI) and where recent declines in the 30-year mortgage rate (to 6.6% compared to 7.8% in October) have driven an increase in refinance and home-builder activity.

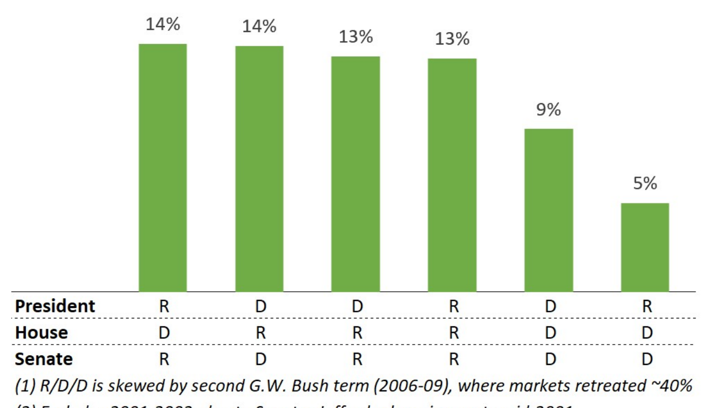
Geopolitics adds to the range of market outcomes. Another key item to consider in 2024 is the uncertain geopolitical environment. Abroad, there is little sign that the wars in Ukraine and in Gaza will conclude any time soon. In addition, attacks by Iranian-backed rebels on shipping lanes has heightened global tensions. Here in the United States, with the Iowa caucus now in the books, election season is in full swing. While it is too early to predict the election outcome, presidential elections have historically been a positive market event irrespective of the outcome. As depicted in **Exhibit 3**, markets have performed well in the fourth year of a Presidential term, moving higher 100% of the time with a 15.5% average return. Markets tend to start the year slowly in the first quarter but strengthen as the year matures, and election-related uncertainty is resolved. Further, irrespective of the result of the election, history suggests that there is no material difference in market performance across the various potential outcomes, with each combination generating a mid-to-double digit return. As a result, we are most focused on the market impact from the direction of the economy, inflation, and interest rates, but continue to monitor the election process for individual winners and losers from any new legislation.

Exhibit 3: Historically, the lifting of election-related uncertainty has been a tailwind for markets in the fourth year of an election cycle, while the election outcome has been a less material driver.

Market performance, by year of election cycle (1928-2022)



Market performance, by government leadership (1933-2022)



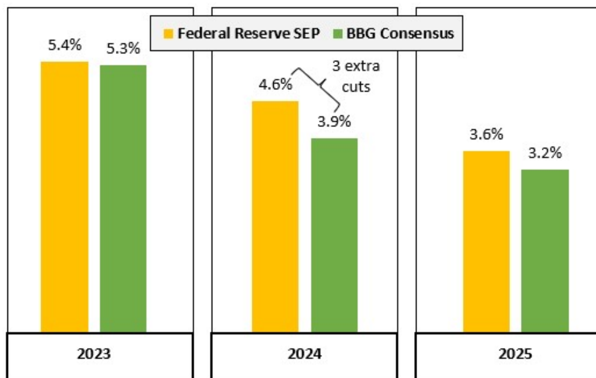
Source: United Asset Strategies, Strategas

Market Outlook & Portfolio Positioning

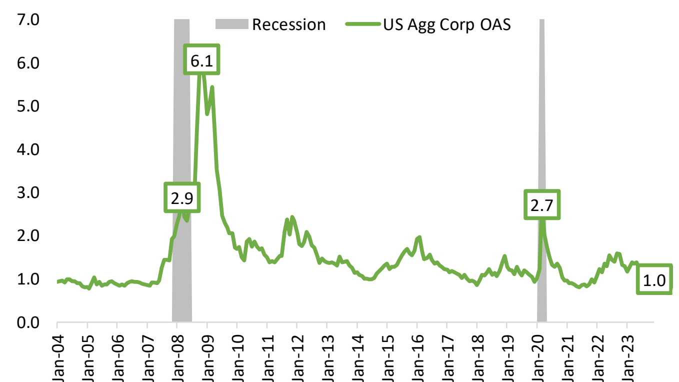
How much of what investors expect in 2024 was already delivered in 2023? Given the decrease in interest rates and corresponding fourth quarter rally in bonds, the bond market enters 2024 more richly valued. The extent to which a soft-landing is increasingly priced in is depicted in **Exhibit 4**, in which we highlight that the market is pricing in three more cuts to the Fed Funds Rate than the Fed guides us to for 2024. Further, corporate credit spreads have narrowed to just one percentage point as of year-end, which suggests the market is underwriting a healthy economy with lower default rates. For example, a long-term high-quality corporate issue, like a 10-year Apple bond (AAPL), yielded 4.1% at the end of the fourth quarter, lower than the 5.3% yield in the third quarter. While the decline in inflation and resilient economy are encouraging, we acknowledge that the bond market is now priced for such strength. And, while the direction of travel may prove accurate, there may be bumps in the road as data rolls in, which could translate into some volatility along the way.

Exhibit 4: Probabilities of a soft landing have increased, but that already appears priced into bonds.

Market vs. Fed expectations for the Fed Funds Rate



Corporate Options Adjusted Spread (OAS)



Source: United Asset Strategies, Bloomberg Financial

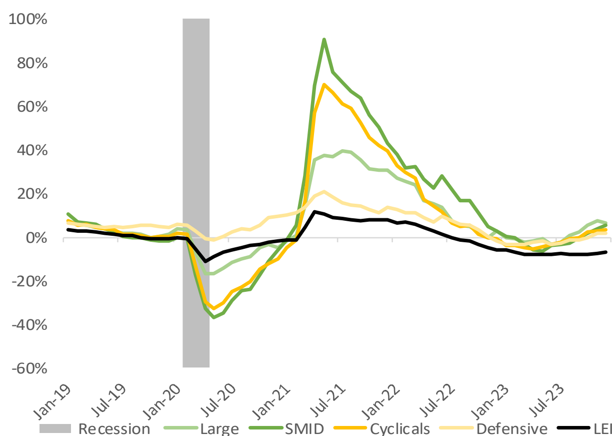
After a strong fourth quarter, stocks are also more expensive, exiting 2023 at 20x earnings, above its 16x long-run average, and up from 18x in the third quarter. In our last letter, we defended valuation, as excluding *The Magnificent 7*, most stocks in the S&P 500 (*the remaining 490+ stocks*) were cheap at 14x. Given the fourth quarter's broad-based performance, that valuation argument is not as strong. At year end, the other 490+ stocks now trade at 16x, which is in line with the historical average for the equity markets. Said another way, investors no longer assign a discounted valuation to the typical stock, seemingly less concerned about the downside risk to earnings from a recession. So, with stocks rallying on an increased likelihood of a soft landing, we enter 2024 with added downside risk should it not occur.

We remain invested, but tilt exposure away from areas of uncertainty. We are cautiously optimistic on the economy and market, and we opportunistically put some of the excess cash in many of our equity strategies to work in the second half of 2023. Still, given the level of uncertainty, we remain focused on managing risk, with one example being our tilt toward defensive sectors (compared to cyclical ones) and small-to-mid (SMID) cap stocks (compared to large ones). In **Exhibit 5**, we show the strong relationship between the US Leading Economic Index (LEI) and next twelve-month consensus earnings forecasts (NTM EPS). Further, certain parts of the market are more geared to the economy than others, with EPS for cyclical and SMID-cap stocks seeing outsized strength in a growing economy, but outsized pressure in a recession.

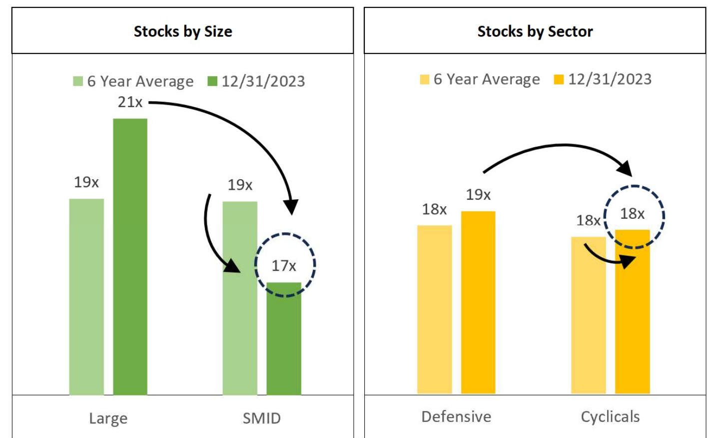
Despite similar economic sensitivities, however, cyclicals trade in line with their historical average, while SMID-caps trade at a discount, suggesting that the former may be pricing in a stronger economy while the latter a weaker one. As a result, SMID-cap stocks have less relative downside risk if a recession unfolds but more upside potential if a soft-landing materializes. With the Fed SEP and US LEI providing contradicting signals on the direction of the economy, we have maintained exposure to economically geared stocks but have chosen to do so through a tilt toward less risky, attractively valued SMID-caps stocks (*and away from more fairly valued cyclical stocks*).

Exhibit 5: Much like cyclicals, SMID-caps are sensitive to the economy. Unlike cyclicals, SMID-caps trade at a discount, reducing risk if a soft landing does not occur and providing upside if it does.

Annual growth for LEI & NTM EPS, by size & macro category



Current & Historical P/E, by size & macro category



Source: United Asset Strategies, Bloomberg Financial, Morningstar

Given that the bond market is now pricing in over six interest rate cuts in 2024, versus an average of three from the Fed SEP, there is risk that bond-market expectations move closer to that of the Fed at some point in early 2024. This could result in pressure to bond prices through higher rates across the maturity curve and widening credit spreads. Considering this, during the fourth quarter we sold some long-term bonds and trimmed our high-yield bond exposure, capturing some of the recent price appreciation. We reinvested proceeds in short-term, floating-rate Treasury bonds, which are highly liquid and currently offer an attractive yield. These floating-rate Treasury bonds act as dry powder and would facilitate opportunistic buys that may arise from any potential market volatility that we encounter.

In closing, the trajectory of the economy and markets remain strong, but the future is always uncertain, and we continue to manage client portfolios to be resilient to a wide range of scenarios. For 2024, we are focused on the pace and extent of Fed rate cuts, the resilience of the economy, and their market implications and will manage client portfolios accordingly.

Please click the link for our Quarterly Market Update Webinar (United Asset Strategies Quarterly Insights: January 2024).

United Asset Strategies Update

We are happy to announce that we are expanding our investment team through the hire of fixed-income industry veteran Keith Douglas. We are confident that his passion for bond trading and analysis will further add to our fixed-income offering.

Respectfully submitted by the Professional Staff at United Asset Strategies

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