As we close in on year-end, there are concerns that the U.S. economy will slip into recession in the new year, and even though inflation remains well above the FOMC’s 2.0 percent target rate, the Committee finds itself trying to push back against market expectations of aggressive Fed funds rate cuts. If this sounds familiar, that’s probably because 2022 ended with us having the exact same discussion. That 2023 is ending on the same note does not mean that nothing has changed over the past year. Indeed, little about the economy in 2023 played out as was expected a year ago at this time, with the U.S. economy proving to be surprisingly resilient in the face of elevated inflation and significantly higher interest rates. By way of a not so bold prediction, we’ll offer that we won’t be having this same discussion as 2024 nears its close. Us going any further out the proverbial limb will have to wait for next month’s edition.

The U.S. economy is clearly slowing as 2023 draws to a close. The second estimate from the Bureau of Economic Analysis (BEA) puts Q3 real GDP growth at an annual rate of 5.2 percent, up from the original estimate of 4.9 percent on upward revisions to the initial estimates of business spending on structures and government spending. That said, the pronounced slowdown in growth in Q4 that we’ve for some time expected seems to be well underway. The Institute for Supply Management’s (ISM) November survey showed a thirteenth straight month of contraction in the manufacturing sector, with new orders having contracted in each of the past fifteen months, the longest such streak since 1980-81. At the same time, backlogs of unfilled orders thinned further in November while firms’ assessments of their customers’ inventories point to those inventories being in the “just right to too high” range. Doing the math, contracting new orders, shrinking backlogs of unfilled orders, and customers at best not looking to build inventories all adds up to a weak outlook for employment and production in the factory sector. That this comes thirteen months into a contraction makes it all the more discouraging. Recall that earlier in the year ISM was reporting firms holding on to workers on the premise that demand would rebound over the second half of this year. With those expectations having largely been dashed, manufacturing layoffs have become more common.

Though none of the official measures of consumer spending for the month of November have yet been released, various spending trackers suggest a somewhat lackluster month for consumer spending after what was only modest growth in October. Not exactly an encouraging start to the holiday shopping season. While various trackers of consumer spending show November was a strong month for online sales, that strength seems to have come at the expense of in-store shopping. Still, there is one hopeful sign for holiday season spending, with the University of Michigan’s early-December survey showing consumers feeling a bit more upbeat and a bit less stressed about inflation, with falling gasoline prices largely accounting for this shift. One may be excused for wondering what took so long, as retail gasoline prices have been falling sharply since September yet, in stark contrast to historical patterns, falling pump prices did nothing to improve consumers’ moods. It could be that, even if November spending is as soft as the various spending trackers suggest, spending perks up in December. That still leaves the question of how consumer spending will fare once the calendar turns, and we continue to expect fairly tepid growth in real consumer spending in 2024.

Real business investment in equipment and machinery contracted in Q3, the third contraction in the past four quarters, and the monthly data on core capital goods orders suggests spending on equipment and machinery will continue to contract well into 2024. While real business investment in structures has been notably strong over the past four quarters, there is reason to question how much longer that will remain the case. Much of that growth has come from the construction of facilities to produce semiconductor chips, electric vehicles, and electric vehicle batteries, activity which has benefitted from government subsidies, and there are signs that this wave of construction is cresting. If so, should business investment in
INVESTMENT STRATEGY OUTLOOK

DECEMBER 2023

November held true to historical form as a good month for stocks as the S&P 500 rose 9.1% on a total return basis and the small-cap Russell 2000 turned out an equally impressive 9.2% return. Broadly speaking, we expect stocks to build on last month’s gains in December, driven by an end to tax loss harvesting, performance chasing, and investors jumping on board to ride a Santa Claus rally expected to occur during the last week of the year. While market breadth improved to begin the month, an encouraging sign, December’s gains may be backloaded as stocks entered the month on the doorstep of overbought territory and may need to digest November’s run-up before resuming their ascent. As such, market participants and the FOMC remain on different pages in their expectations of the path of monetary policy. Slowing economic growth and further deceleration in inflation have led many market participants to pull forward expectations of the initial cut in the Fed funds rate and expect more cuts than had been the case. The FOMC continues to push back on that premise but can only be so forceful in doing so in light of evidence of slower growth and further deceleration in inflation. Still, market interest rates fell meaningfully during November and overall financial conditions have eased, and while the FOMC’s messaging may help check these movements, it is unlikely to reverse them. One factor on the FOMC’s side, however, is that bank lending standards remain notably elevated, acting as at least somewhat of a brake on growth in household and business spending.

We have, over the past two years, been in the small minority of forecasters who at no point have had recession as their base case. At the same time, though, we have expected only middling growth and the economy easily outperformed our expectations in 2023. We’re setting a similarly low bar for economic growth in 2024, and while the economy may well clear that bar, it could be a much closer call than was the case in 2023.

Sources: Bureau of Economic Analysis; Bureau of Labor Statistics; Institute for Supply Management; University of Michigan Survey of Consumers

STOCKS

The Calendar Remains Kind Into January

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December has a well-earned reputation as a good month for stocks but has a particularly strong track record in calendar years such as this in which the S&P 500 enters the month with a year-to-date return of greater than 10%. A positive seasonal backdrop, improved market breadth during November’s rally, and range-bound interest rates through year-end are all potential catalysts for stocks to end the year higher than where they were at the start of this month. However, after a 9.1% return in November, the S&P 500 is now higher by over 21% year-to-date, and we would temper our expectations as a result. The ‘Magnificent 7’ are, deservedly, richly valued relative to the broader S&P 500, with an average price-to-earnings (P/E) ratio on expected 2024 earnings of 26 for the group versus the S&P 500 at just under 19. This could pose a headwind for the S&P 500 next year once investors are no longer chasing their benchmark, but holiday cheer will likely prevent a deep drawdown in this cohort of stocks into year-end.
Interest rates moved lower throughout November as inflation eased and Fed officials struck a less hawkish tone. Historically, December’s leadership tends to persist into the following calendar year, which would make a sustained rotation out of mega-cap growth and into pockets of relative value and SMid this month notable. That could, however, present a headwind for the S&P 500 next year should the heavyweights in the index pull back as investors raise capital to deploy into this year’s laggards for a catch-up trade. We remain neutral across all equity sub-asset classes into year-end as we await opportunities to tactically take advantage of opportunities as they arise.

**Emerging Markets Gain Amid U.S. Dollar Pain.** On the heels of cooler U.S. inflation readings in recent months, market participants have pulled forward expected cuts to the Fed funds rate. Fed funds futures now place the likelihood of at least a 25-basis point rate cut by May of 2024 at greater than 75%. Due to this shift in expectations, the U.S. dollar has weakened materially, giving ground versus both developed and emerging market currencies in November. The dollar’s weakness relative to emerging market currencies is particularly notable as the Mexican peso, South Korean won, and Brazilian real, among others, rallied sharply, propelling equity indices tied to each of those three countries to 14% or greater monthly gains. The impact of China on the MSCI Emerging Markets (EM) index is always cited as cause for concern and well documented issues facing the country have weighed on investor demand for broader emerging markets exposure, leading many investors to be underexposed to developing market equities. Emerging market central banks beginning to cut rates to spur growth could give investors a nudge early in the coming year and provide a tailwind for EM stocks. Active managers willing to run a portfolio that appears different than their benchmark should have opportunities at the country and individual security levels to drive alpha in 2024, and while we remain neutral on emerging markets relative to our strategic benchmark, should the U.S. dollar weaken further and return to pre-COVID levels, emerging markets could be set up to outperform our expectations.

**EM Equities Could Play Catch-Up To Strength In EM Currencies If History Is Any Guide**

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**BONDS**

**Move Lower In Yields Makes Sense, But May Be Overdone**

While we continue to expect the S&P 500 to outperform SMid into year-end, a rotation was afoot at the start of December and a melt-up can’t be ruled out as the mere absence of news – both good and bad - could be enough to sustain positive price momentum for small-caps and value-oriented areas. Historically, December’s leadership tends to persist into the following calendar year, which would make a sustained rotation out of mega-cap growth and into pockets of relative value and SMid this month notable. That could, however, present a headwind for the S&P 500 next year should the heavyweights in the index pull back as investors raise capital to deploy into this year’s laggards for a catch-up trade. We remain neutral across all equity sub-asset classes into year-end as we await opportunities to tactically take advantage of opportunities as they arise.

Investors who stayed the course and remained allocated to bonds despite a volatile and painful first ten months of the year were finally compensated for doing so as they benefitted from a remarkable rally in bonds with greater sensitivity to falling interest rates. The Bloomberg Aggregate Bond Index returned 4.5% during November, and some longer duration Treasury bonds were knocking on the door of a double-digit total return for the month. The yield on 10-year U.S. Treasury notes fell from 4.88% at the end of October to close out November at 4.37%, marking the largest one month drop in the 10-year yield dating back to December of 2008. The reference to 2008 could come across as more ominous than intended as the steep decline in rates back then can be attributed to a recession and skyrocketing unemployment, while this time around positive developments on the inflation front have forced inflation expectations lower, providing a more constructive backdrop for bonds, broadly speaking. The ‘why’ behind the drop in rates matters, and the reasons behind the drop in yields in November are far more encouraging for investors and consumers alike than they were in 2008-2009.
Corporate Bonds, Emerging Market Debt Remain Areas Of Interest Into 2024. Investment-grade (IG) corporate bonds rallied alongside Treasuries during November, evidenced by a 5.9% monthly gain out of the Bloomberg U.S. Corporate Bond index. That index carries a duration of around 7 years, making it more sensitive to falling interest rates than the Bloomberg Aggregate Bond index. Should yields in the 2- to 5-year portion of the Treasury curve fall as inflationary pressures continue to wane and the FOMC cuts rates in the back-half of 2024, investors in IG corporate bonds could fare better than the index’s current 5.4% yield-to-worst (YTW) in the coming year. Lower quality, shorter duration high yield bonds have fared well in 2023, exhibited by the Bloomberg U.S. Corporate High Yield index’s 9.3% year-to-date total return through November. Market participants appear to be growing more confident that the U.S. economy is going to achieve a soft landing, and with inflation trending lower and the labor market remaining relatively strong, we’re finding it increasingly difficult to argue with that stance. A soft landing would likely provide a constructive backdrop for both investment-grade and high yield corporate bonds, although we do expect bankruptcies and defaults to rise modestly over the coming year as Fed funds rate hikes are felt. As a result of this view, it’s reasonable to expect the U.S. Corporate High Yield index to generate a total return modestly below the index’s 8.25% YTW in the coming year.

Emerging market debt (EMD) has performed well in 2023. The J.P. Morgan Emerging Markets Bond index (EMBI) generated a total return of 5.4% year-to-date through November, easily outpacing the Bloomberg Aggregate’s 1.6% total return over the same time frame. We’ve long harped on right-sizing exposure to EM debt due to the asset class’s volatility profile and its susceptibility to sizable drawdowns, but if sized appropriately at a max exposure of 5% of an all-fixed portfolio and around 2.5% of a diversified stock/bond portfolio, an allocation makes sense to us as a diversification tool and a total return driver. While we are constructive on the fundamental drivers of emerging market debt, broadly speaking, should the U.S. dollar weaken in the coming year as we expect, the EMBI could post a return more than its yield-to-worst (YTW) of 7.4%. Notably, while we are currently comfortable with our allocation to EM debt, given the volatility of the asset class, we don’t expect to increase that position, but investors currently with no exposure to EM debt may want to discuss the pros and cons of allocating to the space.