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FOURTH QUARTER
2023 REVIEW

January 17, 2024

Dear Friend,

At the outset of 2023, nearly every economist believed the U.S. economy was headed for a recession. When interest rates rise as quickly as they did in 2022—and the yield curve remains inverted for such a long stretch of time—a recession is what everyone *should* expect. Yield curve inversions have preceded the last eight recessions. For many market participants, the U.S. economy was spiraling towards 1970s-style stagflation.

Equity markets told a different story. With the benefit of hindsight, we can now frame last year's powerful rally as ongoing confirmation that the U.S. economy could, in fact, experience declining inflation **without** a broad-based recession and/or a spike in unemployment (hard landing).

Indeed, U.S. GDP growth surprised to the upside (especially in the third quarter), and nearly 2.7 million new jobs were created last year—a very solid pace of jobs growth relative to a typical economic expansion. Core inflation also fell sharply, and the 10-year U.S. Treasury bond yield—despite experiencing a sharp increase to ~5% in the fall months—finished the year virtually flat.

In last quarter's letter, we summed up equity market action in a single sentence: "*interest rates went up, and stocks went down.*" The opposite occurred in Q4 2023. Interest rates—and expectations for future interest rates via December Fed projections—went down, and stocks went up. The S&P 500 index rose 11.7% in the fourth quarter and 26.2% for the year, finishing December with a potent "everything rally" that bolstered the prices of stocks, bonds, gold and even cryptocurrencies (see chart on next page).

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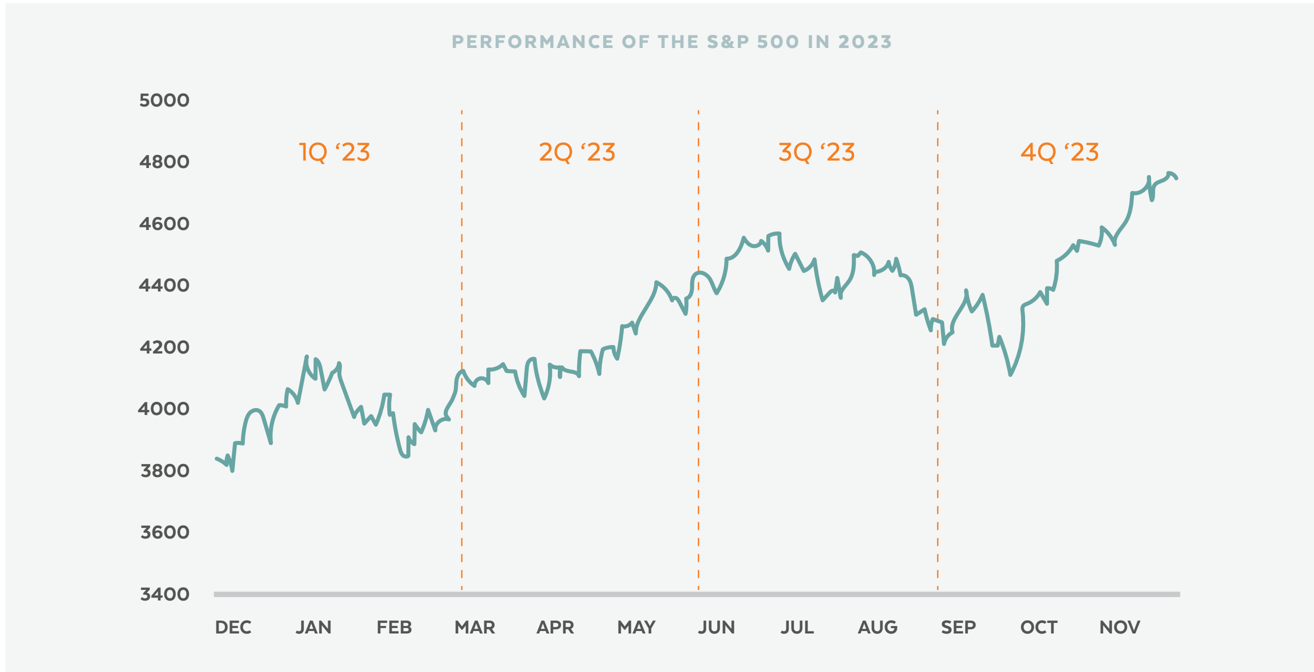


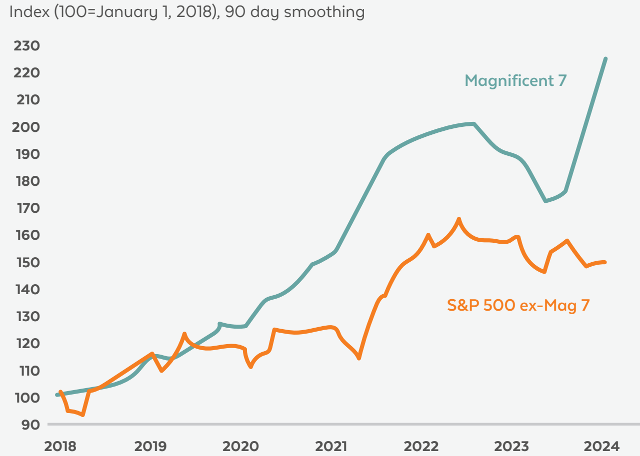
Source: Strategas Research

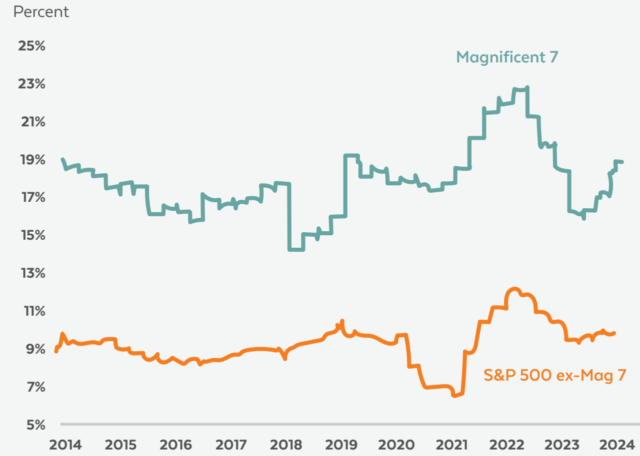
According to Goldman Sachs data, components of the S&P 500's 2023 return included +632 basis points from better earnings expectations, +1791 basis points from a 17% expansion in its forward P/E multiple to 19.51x, and +206 basis points from dividends. As many readers likely know, a lion's share of this attribution came from the "Magnificent Seven" stocks: Apple, Google, Microsoft, Amazon.com, Meta Platforms, Tesla, and Nvidia.

Strategas Research noted that through October 31, the Magnificent Seven accounted for 130% of the S&P 500's overall returns, illuminating the stock market rally's lack of breadth up to that point. It is fair to say that without the influence of these seven stocks, the year does not look nearly as good for U.S. equity markets.

At the same time, it would be unfair to characterize the Magnificent Seven's performance as a signal of a bubble or misguided investor enthusiasm.

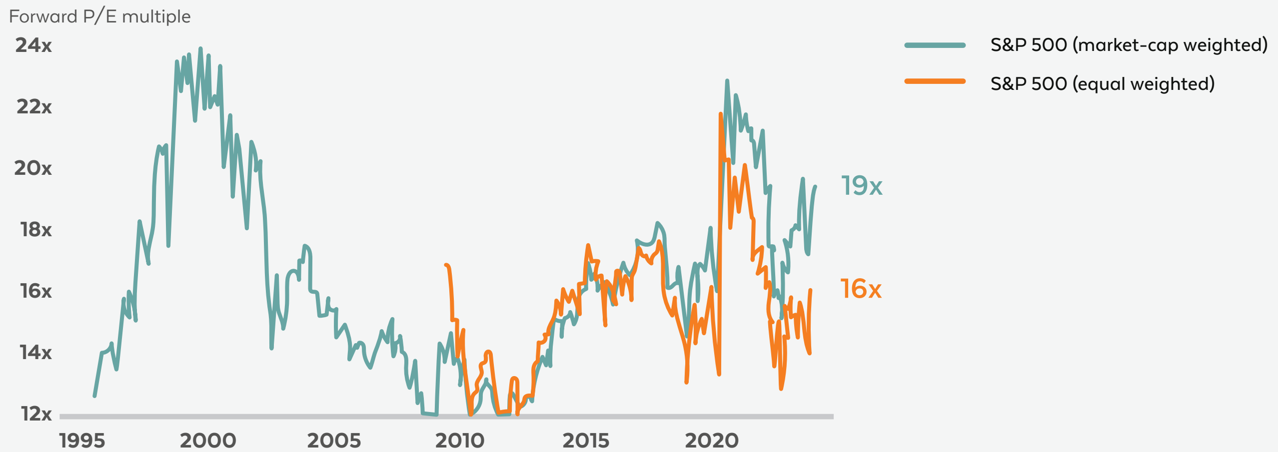
> **The Magnificent Seven seven companies arguably have the strongest balance sheets in the world and generate envious levels of free cash flow, have above-average profit margins, and delivered earnings growth of 33% in 2023 compared to -5% for the rest of the S&P 500.**





Source: Bloomberg, JPMAM, December 27, 2023

A forward P/E ratio of 19.5x on the S&P 500 makes the index look expensive heading into the new year. But the outperformance of the Magnificent Seven obfuscates this valuation narrative. If we look at the forward P/E multiple of the *equal-weighted* S&P 500—which gives equal weighting to the Magnificent Seven and all other 493 stocks—it is evident the stock market is not uniformly stretched (see chart on next page). From this vantage, the forward P/E falls to a more reasonable 16x.



Source: Bloomberg, JPMAM, December 27, 2023

Additionally, when we look beyond US mega-caps, earnings yields look reasonable relative to history, and in many areas valuations have improved relative to last year. We view this as a wide opportunity set, particularly given our belief that positive operating leverage and productivity growth from artificial intelligence should lead to margin expansion across many industries in the coming years.

2024 ECONOMIC AND MARKET OUTLOOK

Looking ahead to 2024, the macroeconomic outlook starts the year in a solid place. The U.S. has a strong employment picture with rising real wages, inflation is trending lower towards the Fed's target, and there are no signs of imminent recession.

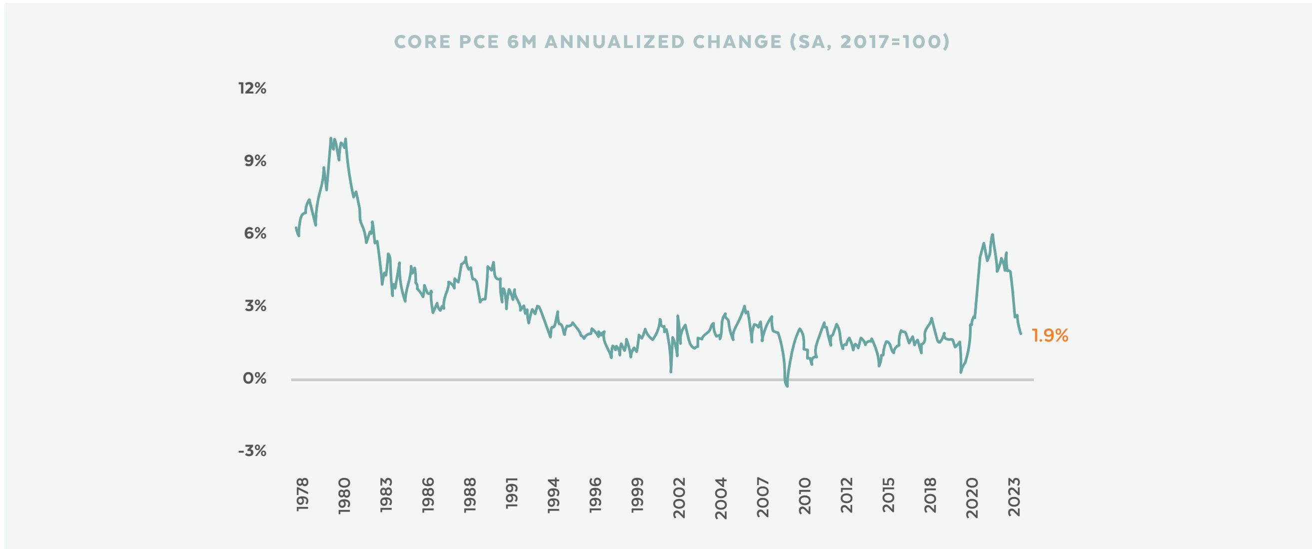
Jobs and Economic Growth

The Bureau of Labor Statistics reported that payrolls grew by 216,000 in December and the unemployment rate remained at 3.7%, both of which were better than consensus estimates. As of the end of 2023, the U.S. economy had 8.8 million job openings (down from over 12 million in March 2022), which signals to us that the labor market has rebalanced via fewer job openings and a lower quits rate, versus outright layoffs.

Wages also continue to rise, with average hourly earnings up 0.44% in November and 4.3% annualized over the past three months. When wages rise faster than inflation, consumers and the economy benefit from higher real disposable incomes, which also bolsters the growth outlook in the near term. Goldman Sachs forecasts that consumer spending will easily beat expectations in 2024, with estimated 2% growth versus consensus of 1%. Strong spending gives way to Goldman's forecast for 2.3% GDP growth in 2024, well above consensus forecasts of 1.3%.

Inflation

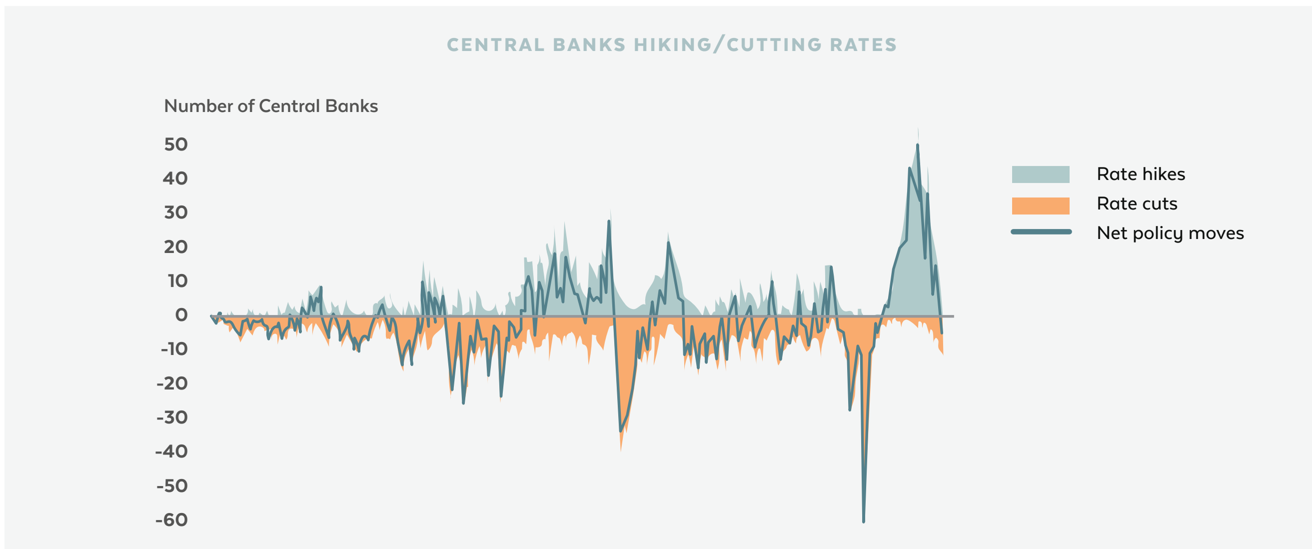
The Federal Reserve's preferred inflation gauge, the headline PCE price index, decreased 0.1% in November and was up 2.6% year-over-year. Importantly, the 6-month annualized change of the PCE price index (1.9%) shows inflation rapidly approaching the Fed's target (see chart on next page) —all but confirming the Federal Reserve is done raising interest rates in this cycle.



Source: U.S. BEA

Even still, the benchmark fed funds rate remains in a range of 5.25% to 5.5%, which is about double the long-term "neutral rate" of 2.5% to 3%. The Fed has acknowledged the current policy rate is overly restrictive, clearly signaling their ability to cut rates even if the economy continues to expand. In projections released following their December meeting, the Fed indicated rates would end 2024 in a range of 4.5% to 4.75%, which implies three 25 basis point rate cuts in the new year. The market generally expects more than three rate cuts, but forecasts tend to be a moving target. At the end of the day, it's all riding on inflation data.

The U.S. is not alone in shifting its monetary policy stance. Globally, central banks have retreated en masse from the tightening regime, with interest rates on net coming down.

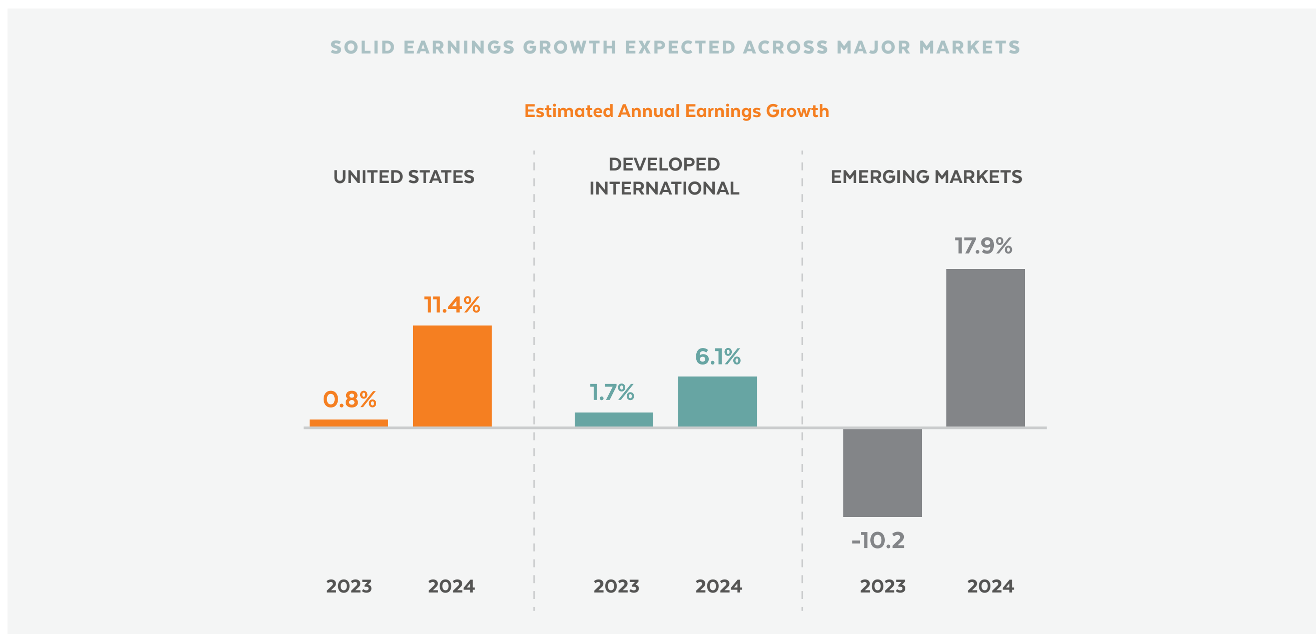


Source: Individual Central Banks, Haver Analytics, JPMAM, November 2023

Chairman of Market and Investment Strategy for JPMorgan, Michael Cembalest, referred to the chart above as the "Chart of the Year" for 2024, underscoring the profound significance of the global shift in monetary policy. The number of central banks raising rates has declined precipitously over the past year, essentially marking the end of the most widespread tightening cycles in decades. This policy reversal does not ensure support for global asset prices going forward, but it does at least mark the dissipation of a major headwind.

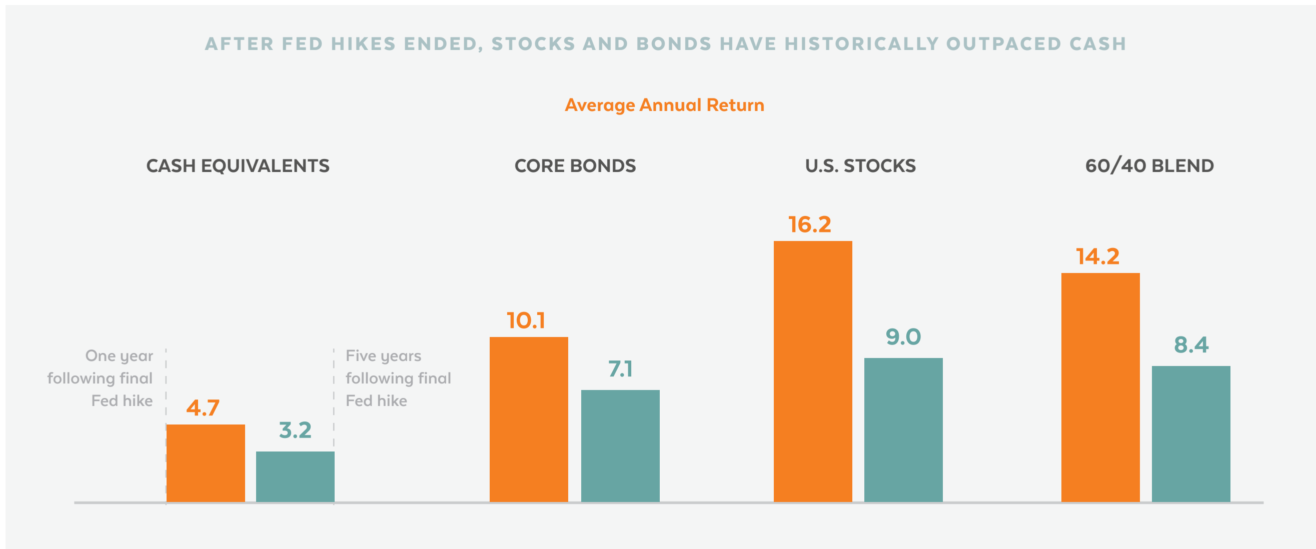
Equity and Bond Markets

More economic growth, moderating inflation, recovering corporate earnings, and falling interest rates should all factor as positives for equity markets in 2024. The Energy sector weighed heavily on aggregate U.S. corporate earnings in 2023, but regardless, there was not much exciting profit growth happening outside of the tech sector. That should change in 2024, with consensus estimates for 11.4% year-over-year earnings growth for the U.S., and notable recoveries in international developed markets and emerging markets.



Source: Capital Group

History also suggests that stocks outperform bonds and cash handily in one- and five-year periods following the end of rate hikes. If we're to assume the Fed's last rate hike in this cycle was in July 2023, it could mean a favorable runway for stocks as financial conditions progressively loosen.



Source: Capital Group

One caveat to consider is that equity markets may have already priced-in an economic soft landing, meaning there's limited upside potential for valuations. That leaves open the possibility that if the market doesn't get what it wants in terms of rate cuts and/or earnings and economic growth, we could experience downside volatility. Therein lies a key strategy theme for 2024: investors should look for small openings in markets that allow for attractive entry points on companies well-positioned to navigate interest rate volatility, while also being well-positioned to grow earnings regardless of Fed policy decisions.

In fixed income markets, the expectation for rate cuts and modest economic growth should keep yields on the long end of the curve from rising materially from here. We also wrote last quarter about the surge in money market funds paying risk-free yields of ~5%, but we see those yields coming down as the Fed moves the fed funds rate lower. Historically, once fed funds peak, money market funds perform poorly relative to all other asset classes, which we think could 'free up' a tremendous amount of sidelined cash—with a possible destination for riskier asset classes.

CONCLUSION

The macro view of stable employment, anchored yields and falling core inflation creates a fundamental backdrop that we believe supports equity prices at current levels.

There is also a good case for upside potential in equity markets, if the supply side of the economy is more positive than expected and if lower inflation allows non-recessionary easing by the Fed. AI's impact on business—which holds massive potential—could also drive profit and productivity in unexpected ways[1].

But as mentioned above, it's important to keep in mind that equity markets have arguably priced-in a good deal of an improving inflation picture and economic and earnings growth in 2024—essentially conceding that central bankers have successfully engineered a soft landing. These assumptions open the door for volatility if everything does not pan out as hoped, or if a material new economic shock arises.

Most importantly though, short-term volatility in the wake of growth, earnings, and interest rate uncertainty should provide us opportunities to buy and/or add to leadership companies participating in major growth themes. Many PWP portfolio companies have exceptional balance sheets to weather the inevitable uncertainties that arise from time to time. And we intentionally build portfolios with this in mind, blending offense and defense to both grow and protect your hard-earned capital.

If you have any questions about this review or your investment portfolio, please do not hesitate to contact us. We hope everyone enjoyed the holiday season, and we wish you a prosperous and healthy new year.

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[1]See our 2023 published paper on Artificial Intelligence
"The Technology Industry's New North Star" – available upon request.

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