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An Unexpectedly Great Year, but Now What?

A summary of the equity market in 2023: earnings down, interest rates up, stocks become even more richly valued on optimism about inflation and Federal Reserve policy, and voila, a 26% total return for the S&P 500 Index. While we were never as pessimistic as the market seemed to be at the worst of conditions in 2022, this year's results frankly defy the investment framework we would normally apply when assessing the market's prospects. How did stocks exceed all expectations?

Simply put, the markets enthusiastically embraced what was only an emerging narrative earlier in the year:

- There will be no recession in 2024, only a further economic slowdown.
- Slower economic growth will (somehow) be accompanied by a significant acceleration in corporate earnings growth.
- Given further improvement on inflation, the Fed will be able to reduce short-term rates, lending support to the economy (avoiding recession) and the markets (justifying high valuations).

This argument strikes us as being internally inconsistent, but even if it turns out to be accurate, it is difficult to map out a path to significant additional upside potential in equities in the very near term absent a major positive earnings surprise. Conversely, this sunny consensus does not allow for a series of risks that remain elevated:

- A protracted yield curve inversion, a collapse in the money supply, and chronic leading indicator weakness all have been historically suggestive of an eventual recession. "Monetary policy works with long and variable lags", it is often said, and we cannot yet know whether the full effects of the Fed's policy reversal in 2022 have been felt.
- Although not dramatically, unemployment has started to rise, and leading indicators of joblessness are concerning; full-time job creation has stagnated in recent months while part-time work and the number of multiple jobholders has surged this year.
- It is premature to take comfort in the prospect of interest rate cuts; the Fed was also reducing short-term rates in advance of the cyclical peaks of 1990, 2000, and 2007, to no avail. The markets may also be overstating the Fed's willingness to adjust interest rate policy in an election year.

These risks cannot be willed out of existence by pervasive optimism, unfortunately. And considering that few things have gone as expected during this extraordinary and unprecedented post-pandemic cycle, it should give investors pause that a picture-perfect "Goldilocks" outcome is being reflected in the markets today.

If this publication had its own motto, it might be that investors should "be open to a wide range of potential outcomes; do not become stuck on a story". Notwithstanding our concerns, we have kept our minds open to the possibility that Goldilocks might be correct! Our current environment is not without its positive aspects:

- Internal measures of equity market momentum are very strong and have a good track record of forecasting further gains ahead. Rising stock prices can and do feed upon themselves.
- The long-term lift to productivity from AI has barely begun, and the companies best able to implement it could see meaningful eventual improvements in profitability.
- Absent a recession, presidential election years tend to be favorable for stocks.
- Although the largest technology names have garnered disproportionate attention over the last year, there is an ample supply of solid and reasonably-valued companies for investors to choose from. The year ahead could be much better for the "average" stock.

Perhaps most importantly, current circumstances, however unique or challenging, should never deter investors from committing to a diversified portfolio of strong, high-quality companies that can grow and outperform for years at a time. These durable leaders have powered our clients' portfolios for decades despite recurring, episodic worries about the macro environment. Similar new opportunities surely will emerge in the post-Covid setting we continue to navigate.

We would like to thank clients of Mid-Continent Capital and readers of *Consilium* for their support, and we offer our best wishes to all for a peaceful, healthy and rewarding year ahead.

Sources: FactSet