Just a Bad Dream? **Q4 2023**

Stocks soared in the fourth quarter. Small caps set the pace, rising 14%, followed closely by the S&P 500, up 11.7%. The year was even better with the S&P 500 closing up 26.3%, followed by small caps' 16.9% gain. How to describe the year? It was a gloom-defying romp with some wicked curveballs thrown in. One particularly wild pitch has to be the resurrection of the Magnificent Seven (the 7 largest stocks of all time, mostly tech), up 76% for the year according to the UBS Magnificent 7 (MAG7) index, and, remarkably, accounting for roughly half the S&P 500's total yearly gain. Brutally sold off in 2022 as rates rose and doubts about their prospects percolated, the MAG7 staged a truly magnificent comeback by reigning in profligate spending, improving fundamentals, and, in a near-miracle of dumb-luck timing, benefitting from the hype-storm called artificial intelligence (AI)…well, mostly hype so far. This kind of high-stakes whipsawing is so cruel it's almost funny.

But let's keep things in perspective. U.S. equity markets haven't gone anywhere in two years. The Seven index, the S&P 500, and the average large cap stock are all about right where they ended in 2021. That symmetry is strange, and it certainly wasn't predictable, but there's a cold logic to it. 2021 ended euphorically as the economy reopened following Covid-19 and unprecedented government stimulus flowed, but as inflation flared and the Fed began its extreme rate hikes, 2022's hangover was guaranteed. The only question: how bad? 2023 dawned with bulls and bears in a ferocious stalemate. Early on the bears gained the upper hand with several scary bank failures, but the contagion was blunted by Fed bank funding guarantees. And as inflation cooled and the economy remained resilient, stocks found their footing. But there was more.

As awe-inspiring and perhaps maddening as the MAG7 were (if you panicked out in late 2022), the bond market was the showstopper. After a series of desperate rate hikes from rock bottom 0.25% in early 2022, the Fed funds target began 2023 at 4.5%, a number it hadn't touched in 15 years--a lifetime in financial markets. This was a potential hammer-blow for funding markets, and as mentioned above, several biggish banks failed. But calm ultimately prevailed. That is until the 10-year Treasury bond cracked above 4% in late summer and kept on pushing to 5% in mid-October. This is the stuff of financial nightmares. Since the Great Recession and Covid-19 collapsed interest rates and exploded debt, there's been a deep unease about the sustainability of super low rates and super high debt. Had we reached some tipping point? Rarely have interest rates moved so seismically. But just as suddenly as rates spiked, the 10-year rolled over and round-tripped back to 4%, taking the last big step down in mid-December after Fed Chairman Powell gave an unexpectedly dovish testimony, signaling that he believed they'd whipped inflation. Higher (rates) for longer--the mantra just a few weeks ago and for nearly a year--was now rates will be coming down. Unambiguously positive for risk assets, an everything rally ensued, pushing bond yields down across the curve and stampeding stocks back up to where they started.

You see, there was a cold logic to it. Inflation tripped us up, and now, exactly two years later, we hopefully have it under control. The economy proved less rate sensitive than feared and has weathered the storm thanks to a strong job market and a flush consumer. Was it all just a bad dream?

Not a dream, but likely a sign we've entered a new era, markets-wise. Covid-19 and its aftermath including the inflation fight are largely behind us. And as hard as it is to not look back, our gaze should be forward. It appears the economy will avoid recession. Stocks aren't cheap, but they are fairly valued, including the MAG7. With the Fed beginning to cut rates sometime in the next couple of quarters and earnings growing, stocks and bonds should have support. But that's as far out on the limb as we're willing to go. If the last few years have reinforced anything, it's that strident market predictions are a fool's game.

It might be a new era for markets, but we still face the same old daunting political and geopolitical problems, too obvious and, frankly, too depressing to waste your time and mine enumerating. How do we not freak out and bury all our money in the backyard? The short answer is remarkable corporate resilience. No matter how screwed up you think our governing institutions are, our big corporations aren't run that way. They, as a whole, are terrific businesses that profitably managed their way through the whole Covid-19 episode, actually ending 2023 with margins near historic highs. Government largess certainly helped, but as we face an unknowable and challenging future, our big businesses are arguably the most dependable asset we have. And as Abraham Lincoln so wisely said: "the best thing about the future is that is comes one day at a time." Companies will adapt. 2024's curveballs could be nasty, but we'll get through. Cheers to 2024!

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