Market & Economic Commentary

Market Performance Recap

The US economy exceeded all expectations for 2023, entering the year with a consensus forecast of recession and instead growing on a real basis (nominal growth minus inflation) in each quarter. Inflation fell throughout the year as supply chain challenges and labor scarcity moderated. With such a resilient economy, investment returns eventually followed suit, exceeding expectations coming into the year, first with the mega-caps and then recently with an expansion across all risk assets. Understanding such a dour outlook to start the year is easy, as the Federal Reserve Bank increased its benchmark short-term Fed Funds Rate significantly in 2022 and continued increasing in the first half of this year. The higher Fed Funds Rate led to increases across all corresponding interest rates (like longer Treasuries, credit card interest and mortgages). Higher rates make borrowing more expensive and constrain the supply of credit, which are usually negative for the economy. However, this year the economy showed a surprising amount of resilience, looking through the higher rate environment to an easing environment. An easing environment is one in which interest rates fall leading the cost of capital and the cost to carry debt to decline. In the last two months of the year, interest rates fell across all maturities which sparked a substantial rally across all risk assets. The lower rates also made fixed income securities more valuable so that even safe-haven assets like Treasuries participated in the rally.

With that backdrop, the fourth quarter shaped up to be the best of the year in the US markets. The large-caps as measured by the S&P 500 Index rallied 11.7% in the quarter which led to a return of 26.3% over the entire year. A phenomenal year by any measure. Throughout the last twelve months you have undoubtedly heard that the market rally was ‘narrow’, meaning that only a handful of the largest stocks were driving returns and the rest of the market was flat or even negative. Well, that turned around in Q4 and the rally broadened out to include the rest of the US market. Small-caps returned 14.0% in the fourth quarter as measured by the Russell 2000 Index, which comfortably outpaced large caps. Small-cap value (Russell 2000 Value Index), which entered the fourth quarter in negative territory for the year, rallied 15.3%, leading the US indices and clawing its way out of negative territory to a gain of 14.6% for the year.

Chart 1: US Equity Index Returns

	4th Quarter	2023
S&P 500	11.7%	26.3%
Russell 2000 Growth	12.7%	18.7%
Russell 2000 Value	15.3%	14.6%
Russell 2000	14.0%	16.9%

Source: OIS, FactSet

Outside of the US, the developed market economic conditions were in accord as inflation fell and rates seemingly peaked. The European Central Bank has stated it has finished raising rates, which sets the ceiling and portends the easing of financial conditions as cuts are expected over the next year. This has been good news for developed market equities (such as Europe, UK and Japan) which enjoyed a strong quarter of returns and benefited further as those currencies appreciated against the US dollar.

Emerging markets have been more of a mixed picture. India had one of the strongest economies on the planet and its market rallied 21.3% (MSCI India Index, in USD) during 2023

while China, the largest weight in the emerging market index struggled throughout the year, returning -11.0% (MSCI China Index, in USD). In both cases, the local currency return and the US dollar return were within one percentage point of each other, meaning that there weren't material moves in the local currency. China tried to reopen its economy, but that was met with mixed enthusiasm by consumers. The hard lock downs enacted during covid pushed some manufacturers to move away from China to protect their supply chains. Net beneficiaries of those moves are Vietnam, Mexico and India. For example, India used to import $1.5 billion of Apple iPhones per year, its entire consumption. Now India exports $2 billion of iPhones per month, net of its consumption (approximately $550 million iPhones per month). A huge turnaround and tremendous growth in the market.

China also has been hurt by sanctions and the specter of additional sanctions. For the first time in decades, there has been negative foreign direct investment in China, meaning more foreign investors pulled capital out of China than invested money into the country. However, the biggest culprit of economic weakness in China has been the falling property market. This market accounts for as much as 30% of GDP and is the largest component of household wealth. As the wealth effect hits consumers (i.e., they feel poorer) they slow down spending, which lessens the demand for discretionary goods and services. The net result in China is youth unemployment that has skyrocketed above 20%, and by some estimates above 40%. University graduates are unable to secure jobs and end up staying home 'laying flat.'

Chart 2: Non-US Equity Index Returns

	4th Quarter	2023
MSCI Emerging Markets	7.9%	9.8%
MSCI EAFE (Developed)	10.4%	18.2%
MSCI ACWI-Ex US	9.8%	15.6%

Source: OIS, FactSet

In the fixed income world, to say the cyclical peak in interest rates has been well-received by bond markets would be an understatement. Going into the fourth quarter, US investment grade bonds were on track for another down year after having their worst performance ever in 2022. Coming off the lows at the end of October, the Fed signaled an end to interest rate increases. This helped investment grade bonds put together their best two-month rally in history. The bond rally resulted in a positive return for the year across all major fixed income markets, foreign and domestic. Japan stands out as the only bond market where yields are continuing to rise, but coming off such a low base, the economy continues to perform well. The slightly higher rates and inflation aren't seen as a cause for concern. The rally into year-end saved the global bond market from two consecutive years of negative returns which also would have made history, but in a far less exciting way.

Chart 3: Fixed Income Returns

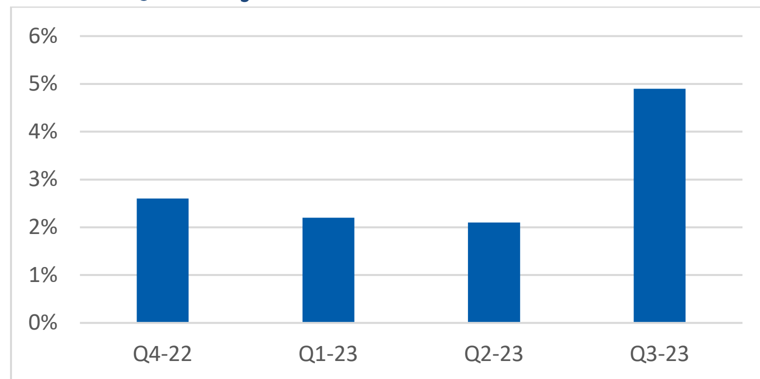
	4th Quarter	2023
FTSE WGBI (USD)	8.1%	5.2%
Bloomberg US Aggregate	6.8%	5.5%
Bloomberg Municipal Bond	7.9%	6.4%
ICE BofA US High Yield	7.1%	13.5%

Source: OIS, FactSet

Economy

In the US, inflation fell. This typically indicates the Fed has created a slowing economy. However, this last year was different, as unemployment remained low and economic growth outperformed all expectations. Leading economic indicators have been starkly negative for almost two years, yet the economy has been resilient. Employment remained strong with the number of available jobs continuing to exceed the number of unemployed people, leading to continued wage growth. House prices have moved up on average across the country, despite higher mortgage rates. Consumption has also continued to rise with demand for services increasing throughout the year. Considering the expectations entering the year, GDP growth has been nothing short of remarkable.

Chart 4: Quarterly Real GDP Growth



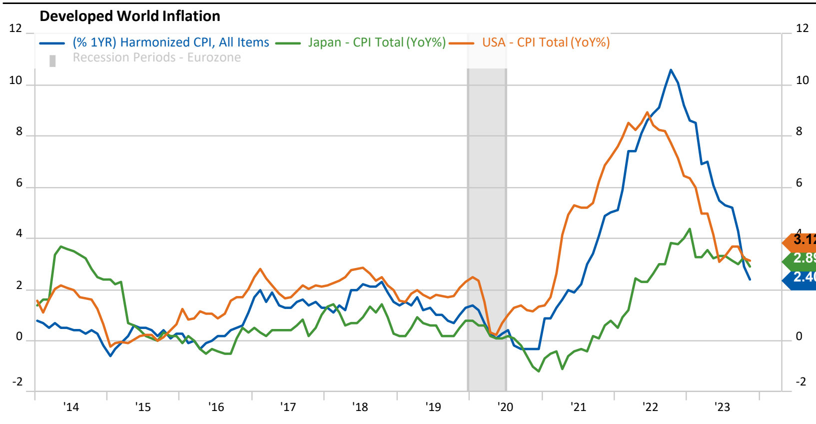
Source: OIS, FactSet (10/1/22 – 9/30/23)

Going into 2024, economic forecasters are no longer predicting a recession. While that doesn't mean we are out of the woods on economic volatility, it does mean that many economists have given up on forecasting gloom and have started believing the soft-landing scenario. The soft-landing scenario is where inflation falls and growth slows but doesn't go negative. Lower rates will take some pressure off banks and encourage more businesses to borrow, while also making cash less attractive to hold. This may encourage additional investment from institutions and individuals. Given the poor track record of economic forecasters lately, their positive outlook might cause us to lose sleep worrying about the downside scenarios. But this is an election year. While most of us grimace at the thought of the barrage of political advertisements, maybe we can take comfort knowing that since World War 2 the equity markets have always had a positive return when an incumbent is running for reelection. Many current projections are for a split Congress which should drive compromise or at least reduce the likelihood of sweeping changes to existing laws and policies. One key theme to watch is messaging around individual tax reforms enacted in 2018 which are set to expire at the end of 2025. This could have a meaningful impact on consumption if taxes were to increase, ultimately taking a bite out of corporate earnings. While the election is likely to take center stage in the press over the coming year, controlling inflation remains the primary focus of the Federal Reserve. Rates should fall if inflation remains in check.

Looking across the globe, the economic backdrop is similar in developed markets where inflation has fallen and interest rates may have reached their cyclical peak. The southern European countries are experiencing a stronger economic rebound thanks to robust tourism and easier monetary policy driving growth. Germany and the Netherlands have seen modest declines in GDP, but even those seem to be turning, with growth in the near-term forecast. Energy

insecurity has been met with new sources of natural gas. Energy prices have fallen precipitously over the last year and a half. A particularly cold winter in Europe could challenge the status quo, but thankfully that hasn't materialized yet. Japan has tamed inflation, though it never dealt with the peaks seen elsewhere in the world. The economy is still growing in Japan and that is expected to continue throughout 2024. Capital market reforms have begun to unlock shareholder value and improve governance across Japanese capital markets. This seems to be in the early innings of a long-term trend, leading us to be bullish on Japan as long as inflation trends lower.

Chart 5: Developed World Inflation



Source: OIS, FactSet

Emerging markets look like they will continue to progress at different speeds. China and countries tied to the Chinese economy look to be mired in malaise for the next year unless the Chinese government can put together a convincing stimulus package to stabilize the property sector and get the 18 – 25-year-old crowd back to work. It's a huge challenge given the demographics and sheer size of the economy. India is expected to grow its GDP by 7% in 2024 and Prime Minister Modi is expected to win his third (and final) term in April. The economic and political reforms he has enacted have proven transformative for the economy. The positive momentum should continue over the coming years; maintaining the strong tailwind for India's equity market. While China and India are the two largest countries in the index, similar divergences can be seen across the smaller countries. For example, Guyana is forecasted by the International Monetary Fund (IMF) to grow its economy by 62.3%, the fastest in the world. Guyana's neighbor, Suriname, is only forecasted to grow by 1.0%. The key takeaway across Emerging Markets is not all countries are on an equal footing.

Essequibo & Oil

Essequibo will be a word everyone knows by the end of the year, possibly much sooner. Essequibo is a region in the west of fast-growing Guyana (remember that 62.3% GDP growth forecast by the IMF). With at least 11 billion barrels of recoverable oil, this country is exhibiting explosive growth. The country invited major oil companies including Exxon Mobil, Hess, and CNOOC to come in and pump oil. In exchange, Guyana expects half of the profit the oil companies produce along with 2% of the overall revenue. This is transformative for the economy of a country that had been one of the poorest in the world. A deeply divided electorate split along ethnic lines plagues the politics in the country, but that isn't the source of consternation. Guyana's neighbor, Venezuela, is claiming Essequibo for its own and gave Guyana three months to vacate the entire western one-third of its country. There was quick condemnation across the global community, something Venezuela is already familiar with. On

the 15th of December, Venezuela and Guyana agreed to resolve the dispute diplomatically and not use force. However, Venezuela has been conducting military exercises to simulate an invasion. In addition, US special forces have been training the Guyanese military and the UK dispatched a naval vessel to Guyana. There is a healthy amount of skepticism surrounding a peaceful resolution.

Ultimately, this is just Venezuela being greedy because it has the largest oil reserves in the world. Venezuela has over 303 billion barrels in reserve and has underutilized that resource for economic development. Another 11 billion barrels probably doesn't do a lot for it. With poor infrastructure and strict sanctions, Venezuela has only pumped about 300 million barrels per year over the last two years. In comparison, Saudi Arabia has pumped about 30 billion barrels during that same period, or 100x as much per year. Essequibo is attractive because Exxon and others have invested over $8 billion building up infrastructure and transportation facilities. Capturing that land and the coastal waters around it creates a plug and play solution to start generating revenue for Venezuela. It seems likely that the US and China will have a say in the matter before it is resolved, given their presence in Guyana's oil industry.

Chart 6: Oil Reserves By Country

Rank	Country	Billions of Barrels
1	Venezuela	303.8
2	Saudi Arabia	258.6
3	Iran	208.6
8	Russia	80.0
10	United States of America	44.4
15	***Guyana***	***11.0***

Source: OIS, Insider Monkey, November 6, 2023
https://www.insidermonkey.com/blog/20-countries-that-have-the-largest-oil-reserves-in-the-world-1217093/

If nothing else, we expect 2024 to be an interesting year. If you have questions or would like to discuss any of these topics in greater detail, please don't hesitate to contact us.

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