DECEMBER: MORE GAINS FOR STOCKS & BONDS
2023 YEAR-END MARKET PERFORMANCE REVIEW

Figure 1: 12/31/2023 Returns (source: Bloomberg)
Conditional formatting: green (high) to red (low) for each time period

Bonds	ETF	Month	QTR	1YR	vs. 52-wk High	vs. 52-wk Low
US Aggregate Fixed Income	AGG	3.7%	6.8%	5.7%	-1.9%	8.4%
Investment Grade Corp Bonds	LQD	4.9%	10.1%	9.4%	-1.6%	12.6%
U.S. Treasury Bonds	GOVT	3.2%	5.6%	4.2%	-2.6%	6.7%
U.S. 20+ YR Treasuries	TLT	8.7%	12.9%	2.8%	-9.6%	20.0%
Muni Bonds	MUB	2.3%	6.7%	5.6%	-0.4%	7.6%
US High Yield	HYG	3.2%	7.1%	11.5%	-0.9%	8.0%
Non-US Corp Bonds	IBND	4.1%	11.3%	10.4%	-1.3%	12.1%
Emerging Markets Bond LC	EMLC	2.9%	8.4%	11.2%	-2.9%	9.7%
Global Equity						
ACWI Global Equity	ACWI	4.8%	11.2%	22.3%	-0.5%	20.6%
ACWI Global Equity ex US	ACWX	5.0%	10.1%	15.7%	-0.5%	13.7%
International Developed	EFA	5.4%	10.7%	18.4%	-0.4%	14.7%
Emerging Markets	EEM	3.6%	8.0%	9.0%	-5.5%	10.5%
Global Equity by Region						
United States	VTI	5.3%	12.2%	26.1%	-0.6%	25.6%
Europe	IEUR	5.5%	12.0%	19.7%	-0.6%	16.8%
Asia ex-Japan	AAXJ	3.5%	6.7%	5.2%	-8.6%	9.3%
China	MCHI	-2.1%	-3.5%	-11.2%	-27.3%	4.9%
Japan	BBJP	3.8%	7.8%	20.6%	-1.6%	19.6%
Latin America	ILF	7.0%	17.2%	33.2%	-2.6%	33.5%
US Equity						
US S&P 500	IVV	4.6%	11.7%	26.3%	-0.5%	25.8%
NASDAQ 100 QQQ	QQQ	5.6%	14.6%	54.9%	-0.8%	57.4%
US Large Growth	IWF	4.4%	14.2%	42.6%	-0.7%	44.9%
US Large Value	IWD	5.6%	9.5%	11.4%	-0.4%	15.3%
US Eqwt S&P 500	RSP	6.8%	11.8%	13.7%	-0.5%	18.3%
US Mid Cap	IJH	8.7%	11.6%	16.4%	-1.3%	19.7%
US Small Cap	VTWO	12.2%	14.1%	17.1%	-2.3%	24.0%

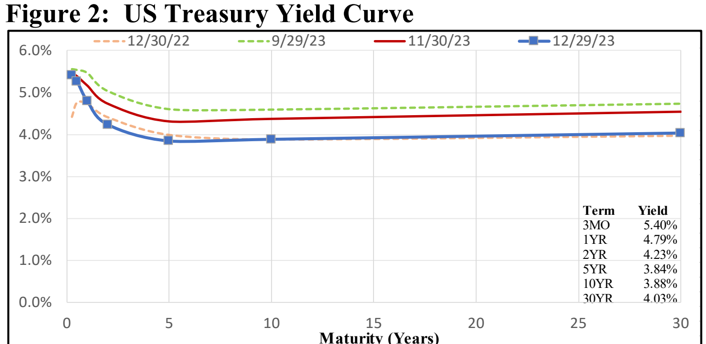
Stocks and bonds continued to surge into year-end, gaining steam in December after Federal Reserve (Fed) forecasts indicated no further rate hikes, with rate cuts beginning as early as mid-2024. Performance highlights for the month and fourth quarter (Q4) are below; a review of calendar 2023 is presented on page 2.

- Bonds: The US Aggregate index (AGG) rose 3.7% in December (+6.8% in Q4) as interest rates declined. (Note: Bond prices rise as interest rates fall.) Long-term Treasuries (TLT) are highly sensitive to interest rates, rising 8.7% (+12.9% Q4). Corporate bonds (LQD) gained 4.9% (+10.1% Q4); high yield (HYG) rose 3.2% (+7.1% Q4). Non-US bonds have out-performed as the US dollar weakened during the year.
- Global equity (ACWI): +4.8% in December (+11.2% Q4).
- US Equity: The broad market (VTI) rose 5.3% (+12.2% Q4). The S&P 500 (IVV) gained 4.6% (+11.7% Q4), but small cap stocks (VTWO) surged 12.2% in December (+14.1% Q4) after under-performing all year. All eleven sectors posted gains for the month. In Q4, falling yields boosted interest rate-sensitive sectors, with solid gains in real estate (XLRE +18.8%) and financials (XLF +13.9%), while tech stocks continued to soar (XLK +17.7%); the energy sector declined in Q4 (XLE -6.4%) as oil prices fell below $72 per barrel of WTI crude.
- Non-US Equity: Developed markets (EFA) rose 5.4% (+10.7% Q4), led by gains in Europe (IEUR) and Australia (EWA). Emerging markets (EEM) rose 3.6% (+8.0% Q4), but returns were mixed, with Q4 gains of more than 18% in Mexico (EWW) and Brazil (EWZ) but losses in China (MCHI).

Interest Rates and the Economy

The yield curve (Figure 2) plots the interest rates (vertical axis) for various U.S. Treasury maturities (horizontal axis). Yields fell in December amid moderating inflation (headline CPI now 3.1% year/year) and the clearest signals yet that the rate-hike cycle is over. In their December meeting, the Fed again held interest rates steady (Fed Funds target range: 5.25-5.50%) and forecast rate cuts beginning in 2024. The inverted yield curve (short-term rates > long-term yields) continues to warn of an economic slow-down or recession. The 10-year US Treasury now yields 3.88%.

Figure 2: US Treasury Yield Curve

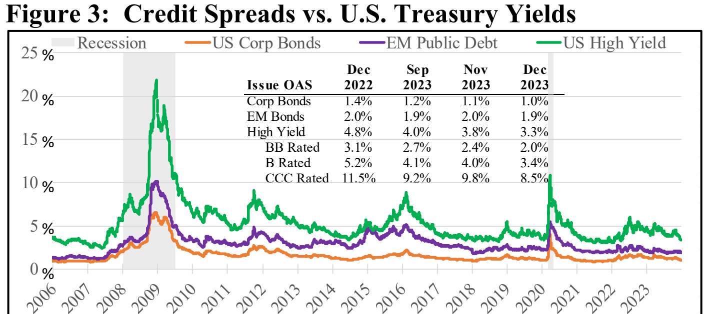


Source: Board of Governers of the Federal Reserve System via St. Louis Fed (FRED)

For bonds other than US Treasuries, we track the option-adjusted spread (OAS) between their yields and Treasuries of comparable maturities (Figure 3). Low or narrowing spreads signal optimism, while high or rising spreads signal fear. Spreads narrowed in December and ended the year at or near historically low levels.

- Investment grade corporate bond spreads narrowed to +1.0% this month and are well below year-ago spreads of +1.4%.
- High yield (non-investment grade) spreads narrowed to +3.3%, down from +4.8% this year. The riskiest bonds (rated CCC & below) declined to +8.5% over Treasuries, down significantly from +9.8% last month and +11.5% spreads one year ago.
- Emerging market spreads declined slightly to +1.9% and have been relatively stable all year. Emerging market credit has out-performed US bonds due to higher yields and stable currencies.

Figure 3: Credit Spreads vs. U.S. Treasury Yields



Source: Ice Data Indices, LLC via St. Louis Fed (FRED)

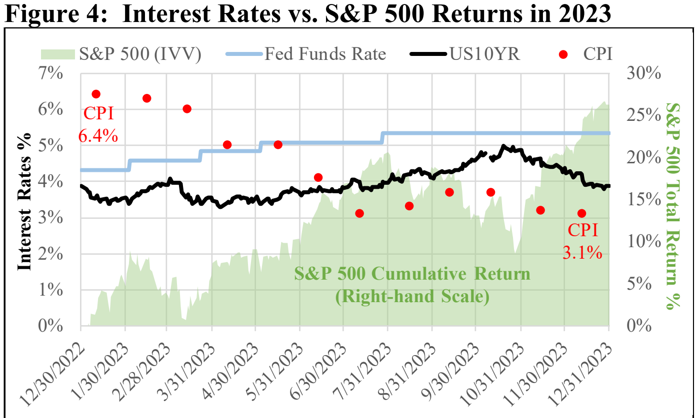
2023 Year-End Review

To say that economic and stock market growth were surprisingly strong in 2023 would be an understatement. After a terrible year in 2022 (soaring inflation, aggressive Fed rate hikes, ugly returns for stocks and bonds), recession seemed imminent. Instead:

- Real GDP growth is expected to be approximately 2.5% for the year (Gross Domestic Product growth net of inflation), in-line with the pre-pandemic growth rates.
- The Fed hiked interest rates to 5.25-5.50% but held rates steady since July as inflation declined to roughly 3% year-over-year.
- US stocks surged, and bonds were positive after two years of historically negative returns due to aggressive Fed rate hikes.

Figure 4 plots the path of inflation, interest rates and the S&P 500 in 2023. It is a busy graph, but it tells the story of the year.

Figure 4: Interest Rates vs. S&P 500 Returns in 2023

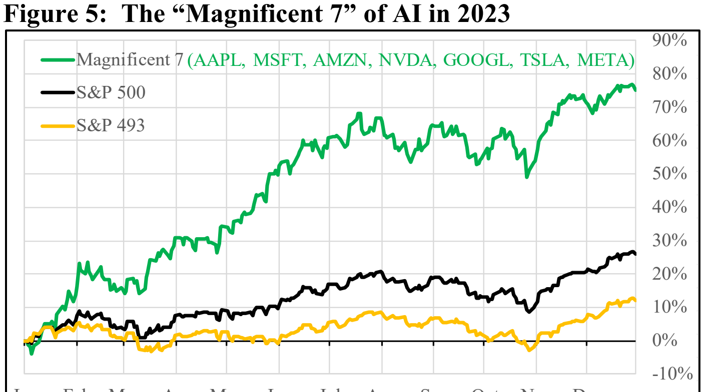


Source: Board of Governors of the Federal Reserve System (US); Bloomberg; Yahoo! Finance

2023 began with headline inflation (CPI – red dots above) running at more than 6% year-over-year. The Fed hiked rates three times early in the year (blue line above) but paused in June after inflation declined rapidly. Equity markets were strong in the first half of the year, recouping some of the losses endured in 2022, but stocks turned negative after the Fed again hiked rates in late July, sending a clear message that rates would remain "higher for longer", driving the 10-year bond yield (black line above) above 4% and increasing fears of a Fed-induced recession. Stocks continued to plummet as the long bond yield approached 5%, but the tone shifted again in early November as inflation eased and Fed rhetoric softened; bond yields fell, and the stocks roared higher.

The S&P 500 gained 26% in 2023, but these stellar returns were driven by a handful of stocks as illustrated in Figure 5 below.

Figure 5: The "Magnificent 7" of AI in 2023

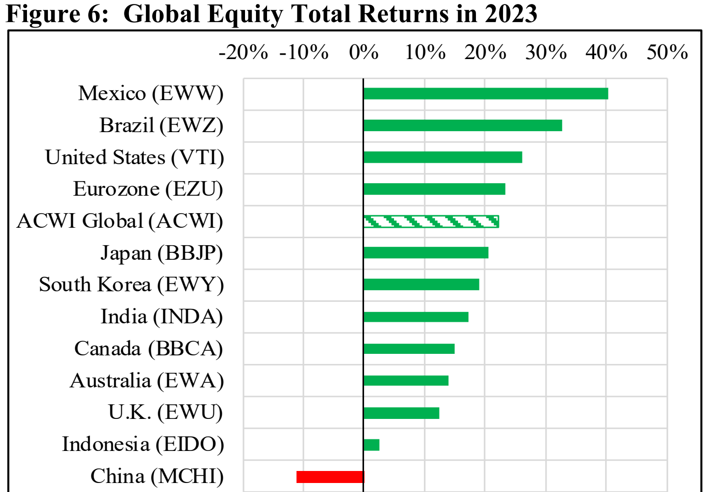


Source: Bloomberg

Stock market returns were dominated by the "Magnificent 7" of Artificial Intelligence (AI), seven companies poised to drive and benefit from the rapid advances in quantum computing: Apple (AAPL), Microsoft (MSFT), Amazon (AMZN), Nvidia (NVDA), Google (GOOGL), Tesla (TSLA) and Facebook (META). The weighted average return for these seven stocks was 75% in 2023! And because they represent over 28% of the S&P 500 index weight, this small group of stocks was the primary driver of market returns. By contrast, the other 493 stocks in the index were up just 12% for the year in aggregate. Interestingly, as of the end of October, the S&P 500 was up 11% year-to-date (YTD); all of that return was due to the strength of the Magnificent 7, as the other 493 stocks were flat-to-down YTD at that time. Positive stock market returns are great, but such narrow leadership is not a healthy sign for the economy and markets. Fortunately, the rest of the market participated in the November-December gains.

As US-based investors, we tend to focus on US markets, but while the US remains the world's largest economy, 75% of global economic activity occurs outside of our borders. Figure 6 below shows the equity performance of the world's 12 largest economies (roughly 78% of global GDP in aggregate), some of which performed as well or better than the US.

Figure 6: Global Equity Total Returns in 2023



Source: Bloomberg

Bottom Line

Markets are hyper-focused on inflation and interest rates. Stocks were weak August-October as strong economic data implied further Fed interest rate increases, but softer inflation and Fed rhetoric led to a strong year-end rally as investors anticipated the end of the rate hike cycle with rate cuts likely in 2024. As we begin the new year, we remain focused on several key themes:

- **Economic Growth:** The cumulative impacts of the Fed's aggressive rate-hike cycle are lagging and yet to be seen.
- **Earnings:** Profits drive stock returns; current prices and valuations already reflect high earnings growth forecasts, especially for the Magnificent 7. Further gains will require continuing economic strength and broader market leadership.
- **Elections:** Elections are a source of uncertainty and volatility; there will be significant, potentially market-moving votes in Taiwan, India, Indonesia, Mexico, the US and other countries.

Volatility is likely to continue, with attractive bond yields offering compelling alternatives in an uncertain environment.

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