Global Market Review

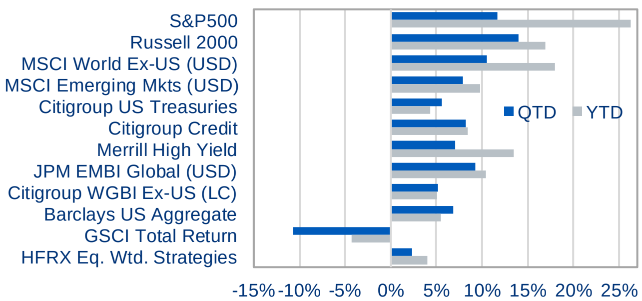
Summary

The year ended with a bang in global markets sparked by expectations that the current tightening cycle was coming to a rapid and happy conclusion. With stocks and long-dated bonds rising by double digits, balanced portfolios enjoyed an exceptionally strong fourth quarter. Declining inflation, economic resilience, and, perhaps, overly optimistic views about the future path of monetary policy sent U.S. equity and bond markets sharply higher, although the gains in the U.S. market remained narrowly concentrated. U.S. Treasury yields fell, and credit spreads narrowed. Global equity markets, with the notable exception of China, also performed well in the fourth quarter, buoyed in part by moderating price pressures and hopes for looser monetary policies. Commodities fell, led by oil. Gold prices rose with geopolitical concerns. The U.S. dollar depreciated against most major currencies.

Exhibit 1

Performance of Major Market Indices

Source: Bloomberg. Year to date through December 31, 2023.



Global stocks and bonds soar in the fourth quarter.

Prospect of Fed Easing Buoys U.S. Equities

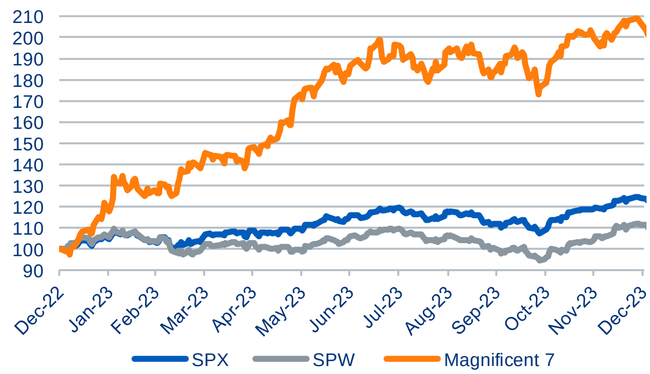
Last year was full of mostly positive economic and market surprises. Defying fears of a recession, U.S. GDP grew 2.5% in 2023, fueled largely by strong consumer demand. Hopes that the Fed would achieve the feat of conjuring significant disinflation without destabilizing markets or derailing economic growth sent U.S. equities sharply higher in the fourth quarter. The S&P 500 gained 11.7% in the quarter, bringing its gains for the year to 26.3%.

The rally was narrowly based, largely driven by multiples expansion rather than earnings growth, fueled increased market concentration, and led to a further deterioration of valuations both relative to U.S. market history and other major markets. The promise of AI set off a speculative frenzy focused on the Magnificent 7 (Alphabet, Amazon, Apple, Meta Platforms, Microsoft, NVIDIA, and Tesla). These stocks, which together represent about one quarter of the S&P 500 index, rose 107%. NVIDIA, the company whose chip is the brain of AI applications, rose 239%. Given the dominance of a few very large stocks, U.S. equity market concentration rose to multi-decade highs. Moreover, the equal- and cap-weighted S&P 500 indices (SPW and SPX, respectively) diverged significantly, with the former up 11.6% in 2023 year versus the cap-weighted gain of 26.3%, a divergence in performance rivaled only by the 1998 dot com bubble (Exhibit 2).

Exhibit 2

AI Frenzy and Falling Yields Propel Stocks Higher

Source: Bloomberg. Index. January 1, 2023 = 100.



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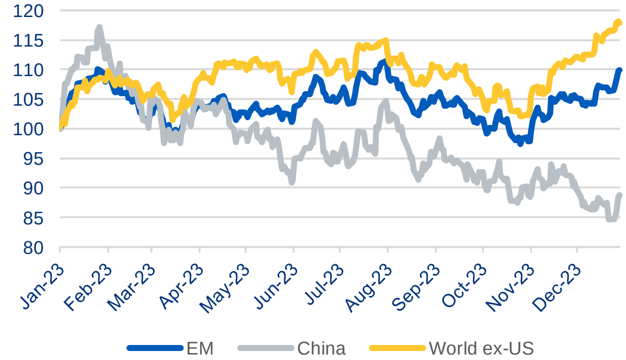
China Weighs Down Emerging Equities

As with the U.S. equity market, advanced and emerging markets rose strongly in the fourth quarter. The MSCI World ex-U.S. index of advanced equity markets rose 10.5% in the quarter and closed the year up 17.9%. Hopes that easing inflationary pressure would allow the ECB to relax its tight policy stance pushed European bourses 19.9% higher in 2023, despite signs of continued economic contraction. Japanese equities rose 20.3% for the year, supported by a combination of economic resilience, the maintenance of low policy rates, a sizable depreciation of the yen, and the implementation of reforms aimed at revitalizing business dynamism.

Exhibit 3

China Lags Advanced and Emerging Equity Markets

Source: Bloomberg. Index. January 1, 2023 = 100.



Emerging equity markets rose 9.8% 2023, lagging advanced economy markets. Disappointing performance in Chinese markets held back the broader index. Chinese equities fell 4.2% in the fourth quarter to close the year down 11.2% (Exhibit 3). A weak post-COVID recovery and deflationary pressures have drawn attention to a number of cyclical and structural vulnerabilities. The Chinese property market, representing almost one third of GDP and three quarters of total financial assets, is overbuilt, overleveraged, and deeply entwined with the financial sector as well as the fiscal position of local governments. Consumer and business confidence has been undermined by erratic economic policy decisions and high levels of youth unemployment. Perhaps most worrisome, China's investment-driven growth strategy appears to have hit diminishing returns. The incremental output gain from additional investment has fallen sharply, and the depreciation costs of past capital expenditure are mounting.

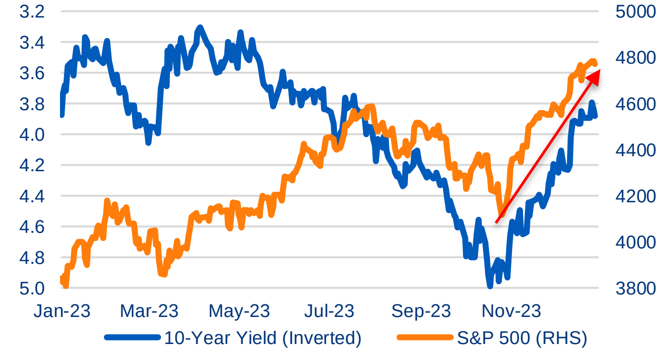
U.S. Treasury Yields Plummet

Equity and bond price movements have been correlated in 2023 with both driven by changing views on inflation and the direction of policy rates. With inflation appearing to slow, the yield on 10-year U.S. Treasury notes plummeted, falling 110 basis points from a mid-October peak of about 5% (Exhibit 4). A strong rally in U.S. equities coincided with this drop in yields. The fourth quarter U.S. Treasury rally of 5.6% erased earlier losses to result in a gain of 4.3% for the year. Treasuries with maturities of 10+ years jumped 12% in the fourth quarter. U.S. investment grade and high-yield credit markets rose about 7% in the fourth quarter, bringing their return for the year to 5.6% and 13.5%, respectively.

Exhibit 4

Falling U.S. Treasury Yields Spark Equity Rally

Source: Bloomberg. 10-yr US Treasury yield (%) S&P 500 index points



The sovereign bonds of other advanced economies followed the pattern of the U.S. Treasury market, gaining 9.9% in the fourth quarter and 5.8% for the year. With the exception of Japan, which has maintained low policy rates throughout, markets widely anticipate an imminent end of the tightening cycle across advanced economies. The EMBI index of emerging market sovereign bonds also rose strongly in the fourth quarter, gaining 9.3%, to bring its gain for the year to 10.4%.

Beta-Heavy Hedge Funds Lead Others

The HFRX equal-weighted hedge fund index rose 2.3% in the fourth quarter and was up 4% for the year. Strategies with a bias toward equity beta and growth have performed best, reflecting particularly strong market gains. For example, beta-heavy equity hedge strategies rose 6.9% in 2023 versus the 4.2% increase for equity market neutral. Convertible arbitrage strategies performed exceptionally well.

Commercial Real Estate Slides Further

Real estate as measured by the NCREIF Open-End Funds Core Index (reported with a delay) lost 12.9% in the 12 months through September 2023 as rising yields and shifting patterns of work and consumption weighed on the market. The office sector was particularly hard hit, losing 17.1%. Only the hotel sector, benefiting from a spurt in post-COVID travel, managed gains, rising 12%.

Private Equity Lags Public Markets

The Thomson Reuters/Cambridge Index of U.S. private equity (reported with a delay) rose 2.3% in the 12 months through June 2023, lagging public markets. Venture capital strategies lost 10.3%, compared to a gain of 8.5% for buyout strategies and a modest 1.1% return for growth equity. Mark downs in late-stage venture capital portfolios contributed to the sharp decline. Across all strategies, transaction activity has slowed significantly. Fund raising is also down, although firms remain flush with dry powder. Tighter credit and a weak exit market are likely to continue to weigh on private equity valuations.

Outlook & Strategy

Markets appear priced to perfection. This pricing is predicated on the hope that the Fed has achieved the rare feat of conjuring significant disinflation without destabilizing markets or derailing economic growth (see this quarter's Special Topic).

In contrast to this sanguine view, the history of past inflationary periods suggests that inflation is persistent. Successful episodes of disinflation have required a sustained period of tight monetary policy that typically culminated in economic contraction. Markets appear to believe that this time will be different.

This belief sparked a U.S. equity and bond market rally in the fourth quarter of last year that amplified imbalances in asset markets and compressed the risk premiums on U.S. equities, long-dated bonds, and credit. Juxtaposed against this optimistic asset pricing is elevated uncertainty surrounding macroeconomic variables and heightened geopolitical risk.

Against this backdrop, our top-down active positioning remains grounded in fundamental valuations. Although the spread in relative valuations across global markets is quite wide, we continue to take a disciplined approach to calibrating our active top-down positioning. This approach is designed to limit the impact of any one risk factor or group of correlated factors on portfolio performance. We believe that prudence in sizing our top-down active positioning is essential for promoting portfolio resilience.

We focus the bulk of our active positioning on identifying skilled managers adept at exploiting opportunities to add value across individual securities. This focus maximizes the breadth of independent active decisions thus increasing the likelihood of sustained added value while achieving a high level of diversification. Our ultimate goal is to build robust portfolios by incorporating multiple sources of diversification and favoring positions whose pricing is supported by strong fundamentals.

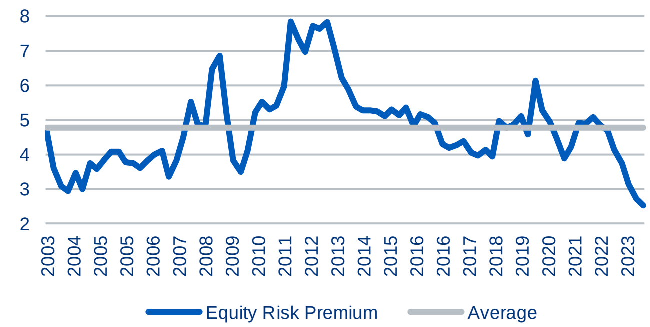
Compressed U.S. Equity Risk Premium

The U.S. equity market is quite overvalued. The equity risk premium is at its lowest level in over 20 years (Exhibit 1). Last year's rally, which was driven mainly by multiple expansion rather than earnings growth, led to a further deterioration of valuations. The market is also imbalanced. The largest gains last year were concentrated on the "Magnificent Seven" stocks thought likely to be the prime beneficiaries of the widespread adoption of Artificial Intelligence. These stocks, which represent about one quarter of the market capitalization of the S&P 500, gained 107% last year.

Exhibit 1

U.S. Equity Risk Premium Falls to 20-Year Lows

Source: FRED. ERP = Equity earnings yield less TIPS real yield.



The risks arising from the U.S. market's overvaluation are compounded by its concentration on a small number of firms exposed to similar risk factors. This concentration has pushed the dispersion of the valuations of rich and cheap U.S. stocks to high levels, thus increasing opportunities for adding value through stock selection. Our active U.S. equity managers are well positioned to exploit these opportunities. Moreover, we have tilted the U.S. equity portfolio away from expensive mega-cap growth stocks in favor of more attractively priced value stocks in the expectation that the wide valuation spreads between these two market segments will normalize.

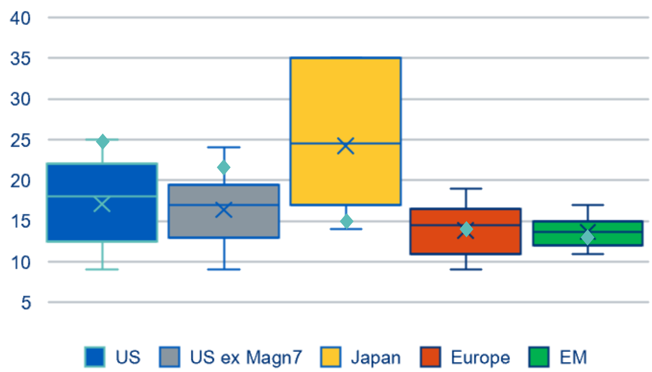
In addition to being expensive relative to its history, the U.S. equity market's valuation is quite high relative to other global equity markets (Exhibit 2). As highlighted in Exhibit 2, the U.S. equity market's valuation is at the 90th percentile. Even excluding the Magnificent Seven from the calculation, the U.S. equity market appears quite overvalued. Other global markets appear much more fairly priced. The Japanese market's valuation appears quite low, while European and emerging markets are at about median levels.

This relative valuation underpins our top-down equity positioning. We are modestly underweight equities overall structured as a significant underweight to the U.S. market that is partially offset by overweight allocations to developed and emerging non-U.S. equity markets. In addition to their relatively attractive valuation, we believe that European markets have the potential to benefit from a recovery in earnings. We see strong potential to add value through security selection in emerging markets given their relative inefficiency. In light of its highly favorable valuation, we have recently added an active manager focusing on the Japanese market.

Exhibit 2

U.S. Equity Valuations High Compared with other Markets

Source: Goldman Sachs. Box plot of valuation levels across markets. Solid rectangles delineate inter-quartile ranges. Lines delineate top and bottom deciles. Diamonds are current levels. X's mark median levels.



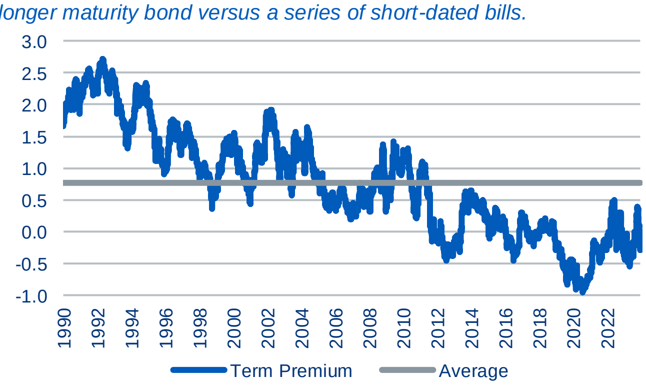
Treasury Yields Fall as Inflation Eases

The yield on 10-year U.S. Treasury notes plummeted in the fourth quarter, falling 110 basis points from a mid-October peak of about 5%. Both falling real yields and declining inflation expectations contributed to this sharp reduction. The decline in 10-year yields resulted in a compression of the term premium measuring the compensation for investing in long-dated bonds versus a series of short-dated bills (Exhibit 3). This premium now stands well below its long-term average but remains above its average since the Great Financial Crisis, a period marked by historically low yields and for the most part low inflation. Which historical perspective is the right one to judge the adequacy of the term premium and thus the likely future path of yields is an open question, one that has contributed to the volatility of the market.

Exhibit 3

Term Premium Remains Low Despite Rate Volatility

Source: Fred. Term premium = estimated compensation for holding a longer maturity bond versus a series of short-dated bills.



We believe that the probability distribution of future Treasury returns remains balanced, and that the valuation of U.S. Treasuries is about fair given the current environment. We are therefore retaining our neutral duration position. The outlook for credit markets, in contrast, is mixed as firms face higher financing costs and the possibility of reduced credit availability. In view of these uncertainties, we are retaining a slight underweight to credit. Within credit, we see opportunities in mortgage asset-backed securities which have a particularly attractive yield and risk profile. We are also expanding our allocation to direct lending to take advantage of opportunities opened up by the retrenchment of bank lending.

Hedge Funds Remain a Key Diversifier

Hedge funds retain two features that make them especially attractive. First, they epitomize our goal of focusing our added value on security selection, rather than timing broad market movements. Second, our approach to hedge fund portfolio construction seeks to minimize market beta while relying on multiple idiosyncratic sources of value added as the main source of return. Because of this portfolio construction, our hedge funds provide important diversification benefits that are central to constructing robust multi-asset class portfolios. Balancing these alpha opportunities and diversification benefits with the desirability of maintaining adequate liquidity, we retain a neutral allocation to hedge funds.

Return to a Neutral Real Estate Allocation

We have moved to a neutral target for real estate following a temporary suspension of new allocations to the market. Although the real estate sector faces challenges from falling demand for office and retail space and reduced credit availability, we see opportunities in other sectors of the market. Industrial, residential, and alternatives such as storage and data centers are benefitting from high demand and rental income growth, providing an inflation hedge. We are also retaining a neutral allocation to TIPS as a further inflation hedge.

Steady Approach to Private Equity

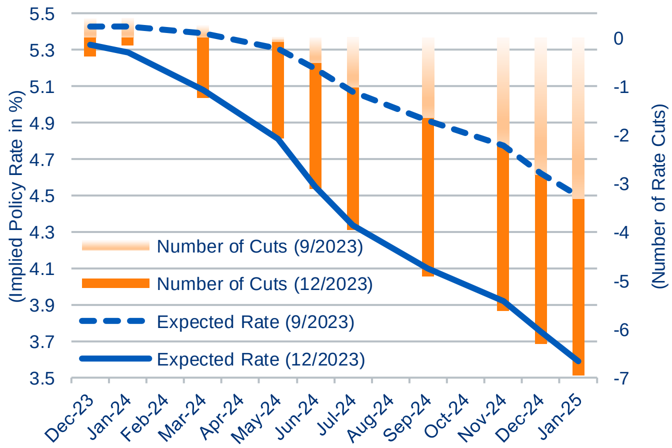
Private equity and especially venture capital face a number of challenges resulting from the excesses engendered by outsized flows into private equity strategies over the past several years. Although these flows have since moderated, the dry powder held by private equity firms remains at record levels. Private equity valuations are declining with venture capital and growth equity strategies experiencing the largest reductions in valuation. Private equity strategies favoring investments in firms in the industrial and consumer sectors with solid earnings growth have been relatively resilient to more costly and less readily available funding. We anticipate continued lackluster returns as economic headwinds, tighter credit, and a weak exit market flow through to valuations. Despite these challenges, we are maintaining a disciplined approach to vintage year diversification as investments made coming out of a downturn typically generate superior returns over time.

Special Topic

Exuberant Expectations

Our proclivity to rationalize and simplify often results in the adoption of single factor solutions to complex problems that are, in the words of HL Mencken, “neat, plausible, and wrong.” This time may be different. The single most dominant determinant of the direction of markets in 2023 and so far in the new year has been widely fluctuating expectations for the direction of monetary policy. Market sentiment has swung from concern that tight Fed policies would reduce price pressures at the cost of a recession to jubilation that the Fed will tame inflation without derailing growth or destabilizing markets. The fourth quarter of 2023 marked a watershed in market expectations for the future path of monetary policy, as a much steeper decline in the Fed funds rate was priced into futures contracts on the Fed funds rate (Exhibit 1).

Exhibit 1
Market Prices in Aggressive Fed Rate Cuts
Source: Bloomberg. Forward Fed funds rate implied by futures market.



This shift in expectations was a prime catalyst for a fourth quarter rally that sent U.S. stocks and long-dated U.S. Treasuries and corporate bonds up over 12%. This combination made the fourth quarter one of the best for 60/40 portfolios of the past century. With this move, markets appeared priced to perfection, and the basis for this pricing appeared largely to rest on expectations for a rapid easing of monetary policy culminating in a rare episode of rapid disinflation combined with sustained economic growth. History suggests that this would be an exceptional feat.

Market Races Ahead of the Fed

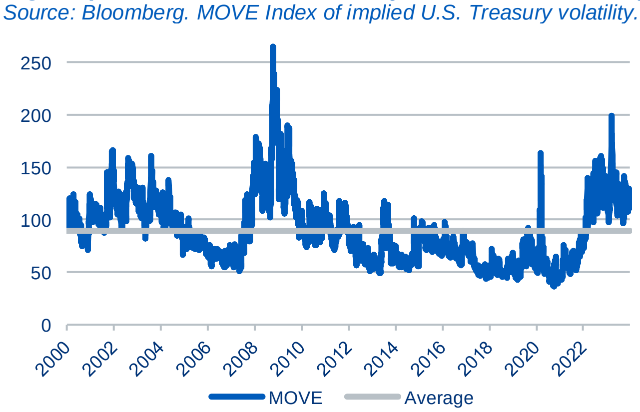
The market appears to have more faith in the Fed’s powers than the Fed itself and expects the Fed funds rate to decline faster than the Fed’s own projections. Current market pricing suggests that inflation will rapidly fall to target, the economy will remain resilient, markets will remain stable, and profits will grow sufficiently to justify current high equity valuations. There are two main ways that these expectations could be disappointed.

First, the economy may yet fall into recession as a result of the lagged impact of past tightening. Some of the factors supporting strong consumer demand, notably including the accumulation of excess savings during the pandemic, are dissipating. Moreover, monetary policy works with a lag as it takes time for the effect of a higher cost of capital to work its way through the economy. There are already signs of the impact of tighter policies. Credit extended by commercial banks is contracting, interest on credit card balances and credit card delinquencies are up, corporations face a higher cost of capital, and higher mortgage rates have disrupted the sale of existing homes. While the economy has so far been resilient, the lagged effect of tight policies may yet be manifested in slower growth.

Second, inflation may not be so easy to quell. A recent IMF analysis of 100 inflation shocks across 56 countries since 1970 highlights important lessons for our current predicament. History suggests that price pressures are persistent. Inflation inertia can be hard to overcome. Successful disinflations require central bank perseverance and have taken 3-5 years of tight policies. Central banks ignore inflation’s persistence at their peril. There are many past instances of a premature relaxation of policies that allows inflation to reignite and ultimately increases the economic costs of disinflation. The sustained policy tightness needed to dampen inflationary pressures typically lowers output and employment, at least for the short term.

Reflecting these risks to the market consensus, uncertainty appears high. Survey-based data on economic forecasts for inflation and interest rates suggest an unusually wide dispersion across forecasts. Market-based measures of expected interest rate volatility derived from option prices also point to high levels of uncertainty about the future path of interest rates (Exhibit 2). Past history suggests that doubts about the market consensus are warranted.

Exhibit 2
High Implied Bond Market Volatility Points to Uncertainty
Source: Bloomberg. MOVE Index of implied U.S. Treasury volatility.



Note: Opinions expressed herein are current as of the date appearing in this material and are subject to change at the sole discretion of Strategic. This document is not intended as a source of any specific investment recommendations.