Investor Optimism Set the Tone for a Strong Finish to 2023

A choir of optimistic investor sentiment closed 2023 on a high note, as expectations of "steep cuts to interest rates" may be at odds with the Federal Reserve's (Fed's) actual sheet music. Considering the tumult of the year as sentiment focused on economic and inflation data, this discordance isn't all that surprising and could signal volatility to come, but in the meantime, the market environment looks a lot brighter at the tail end of 2023 than it did at the close of a dreary 2022.

"December's rally was fueled by a further deceleration in inflation and the Federal Reserve's switch at the last FOMC (Federal Open Market Committee) meeting of the year to a more dovish tone and talk of Fed interest rate cuts in 2024," said Raymond James Chief Investment Officer Larry Adam. "However, it is important to put the positive year of performance into perspective: 2023 was a reset year as the over 25% return for the S&P 500 only recouped all the losses from 2022."

While the Dow Jones Industrial Average notched seven record highs in 2023, the S&P 500 closed the year less than 1% from all-time highs. Tech-related sectors were the best performers for the year, as the NASDAQ 100 and its leading artificial intelligence stocks saw its best year since the 1999 tech bubble. And small-cap equities, which had been a significant underperformer for the year, showed signs of a resurgence as it was the best performer in the fourth quarter.

Still, it may be too soon to celebrate the Fed engineering a "soft landing" – a return to the target inflation rate without a recession. For one, inflation remains above the 2.0% target. Two, the lagging effects of the Fed's rate hike program continue to cool economic activity. And three, the repercussions of higher economic growth or any other geopolitical event with the potential to disrupt food and energy prices could directly influence inflation and shape future Fed policy.

But even a conservative reading of the Fed's messaging suggests interest rate cuts to come through 2024. That said, the Fed has demonstrated its commitment to calming inflationary pressures, and it appears they are turning their attention to the economy where there are more and more signs of slowing.

Before we continue, let's take a final look at 2023 by the numbers.

	12/30/22 Close	12/29/23 Close*	Change Year to Date	% Gain/Loss Year to Date
DJIA	33,147.25	37,689.54	+4,542.29	+13.70%
NASDAQ	10,466.48	15,011.35	+4,544.87	+43.42%
S&P 500	3,839.50	4,769.83	+930.33	+24.23%
MSCI EAFE	1,943.93	2,241.21	+297.28	+15.29%

Russell 2000	1,761.25	2,027.07	+265.82	+15.09%
Bloomberg Aggregate Bond	2,048.73	2,162.21	+113.48	+5.54%

*Performance reflects index values as of market close on Dec. 29, 2023.

Composite index points to recession

The Leading Economic Index, a composite index from The Conference Board that seeks to forecast turning points in the business cycle, declined for its 20th consecutive month in November, weakening further than expected. The Conference Board said it expects a "short and shallow recession in the first half of 2024."

Movement suggests broadening equity market growth

To a significant degree, the incredible performance of a small formation of high-flying, mega-cap tech stocks propped up headline equity indices through 2023, providing a sense of a stronger market than experienced by a more diversified position. The average stock, by comparison, has been in a two-year bear market. Recent activity since the start of the October rally suggests positive movement below the surface, meaning 2024 could bring more opportunity for those stocks left behind. December saw 10 of the 11 sectors finish in the green, with interest-rate sensitive sectors leading the way.

Treasury yields lowered as sentiment improves

Fixed income prices soared, continuing to demonstrate the strength of the market through December. Reflecting improving expectations, the yield on the 5-year Treasury ended November at 4.27% and closed December at 3.85%. The 10-year yield declined from 4.33% to 3.88%. The year's high interest rates allowed investors an opportunity to lock in elevated income levels while the year-ending price strength provided those participants with positive total returns.

Waning OPEC+ vigilance brings oil prices down

Production discipline among the OPEC+ group, amid a return to pre-COVID demand, has been slipping, bringing oil prices to near 2023 lows in December. Particularly, Saudi Arabia and Russia have expressed displeasure at smaller OPEC members that are flagrantly producing beyond their quota levels, cheating the cartel, in effect.

European central banks yet to message lowering rates

Like the U.S.'s Fed, the European Central Bank and Bank of England held monetary conditions steady through December as economic activity continues to slow. Meanwhile, large-cap equities – particularly German stocks – dashed upward to close the year with strength, as the Eurostoxx 600, a composite index of 600 European stocks, hit 23-month highs. Unlike the Fed, the British and European monetary authorities have not signaled the lowering of interest rates. Investor sentiment has swung toward a growth outlook but fears that higher-for-longer rates could unnecessarily deepen and lengthen a recession could cause investor sentiment to rapidly reverse.

U.S. and China resume military-to-military talks

An agreement to resume military-to-military communication secured in November at the meeting of President Joe Biden and President Xi Jinping came to fruition in December, ending a 17-month communications impasse between the two world powers' armed forces. This is generally seen as supporting stability, as military-to-military communications can act as a critical avenue for addressing miscommunications and flare-ups around key geopolitical flashpoints, such as in the Taiwan Strait and South China Sea.

The bottom line

At this time last year, no one could have projected the highs and lows that would follow – the incredible first two quarters, the midsummer reversal, then the even more remarkable end-of-year rally. We start 2024 in much stronger position, owing to the progress made on inflation, and that's heartening – strength often begets strength. However, sluggish economic growth and the potential for investor sentiment to suddenly shift are potential risks, as is the potential of a recession. That's worth remembering, even when the forecast is clear.

Together, we will help you navigate whatever 2024 brings, remaining disciplined in the faces of both exuberance and frustration, and always keeping our eyes on your goals.

Thank you for your continued trust in us and our commitment to your well-being. We wish you good health and tidings and a happy new year.

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