

Equity markets generated surprisingly robust returns in 2023. The S&P 500® Index gained 26.3% for the year and the Russell 2000® Index returned 16.9%. Much of the gains were fueled by a feverish late-year rally. For the fourth quarter alone, the S&P and Russell returned 11.7% and 14.0%, respectively. As you may recall, we came into 2023 with rampant negativity and widespread calls for a recession. While there were hurdles to surmount along the way, markets largely defied the odds and generated very impressive results.

The year brought plenty of wild turns and major developments. While it now seems like a distant memory, we started the year with a banking crisis that exacerbated recession fears and further weighed on stocks following 2022 declines. Soon, however, this disaster was standing in the shadows of the artificial intelligence (AI) craze. AI took the investment world by storm as investors anticipated a wave of innovation and profits. Large technology companies mopped up investor capital and the so-called “Magnificent Seven” were born (Apple, Microsoft, NVIDIA, Amazon, Meta, Tesla and Alphabet). These stocks powered most of the S&P’s gains for a while as many other areas of the market continued to struggle. Later in the year, we saw war break out in the Middle East, adding more tension to an already fragile geopolitical climate.

All the while, the Federal Reserve was busy raising interest rates in an effort to combat inflation. Following a series of rate hikes in 2022, the Fed raised rates four more times in 2023. This brought their benchmark rate to the highest level in 22 years. While the last hike occurred in July, the Fed’s “hawkish” tone continued to concern investors through the third quarter of the year. More recently, however, inflation data has cooled alongside weaker economic readings and policymakers have adopted a softer tone. It now appears the rate hike cycle has ended and, in a somewhat surprising about face, the Fed is even signaling the possibility of interest rate cuts in 2024.

In our last letter, we noted signs of “peak Fed” could breathe new life into stocks. Indeed, this has come to fruition in a major way. Stocks have rallied very sharply to close the year and have very quickly discounted the dream scenario of declining interest rates and a “soft landing” for the economy (i.e. we successfully tame inflation without tipping into a recession). We’ve witnessed somewhat of an “everything rally” that has encompassed almost all corners of the market. Gains have spread to include areas other than the large cap tech behemoths that led markets for most of 2023. Perhaps the most striking example is the small cap-oriented Russell 2000, which gained 22% in the final two months of the year.

This vigorous rally has changed market dynamics. In a short period, it seems investors have shifted from having too much worry to having no worries. To wit, the CNN Fear & Greed Index has moved from “extreme fear” at the end of October to “extreme greed” as of year-end. The S&P 500 now trades for 19.7x projected earnings, which is above the 10-year average (17.8x) and seems to leave little room for further valuation expansion. There’s no doubt that more accommodative (or less restrictive) Fed policy should support markets, and lower interest rates would boost everything from housing activity to mergers/acquisitions. But, investors may be disappointed short term if inflation remains sticky, rate cuts don’t come to fruition as soon as hoped, and/or the economy weakens more than expected.

Despite a dose of near-term caution, we still think there is value to be found in the market. The equal-weighted S&P 500, which adjusts for the heavy weightings of the biggest and more expensive companies, trades for a more reasonable 16.3x earnings. This is clearly up from a few months ago, but still below the 10-year mean of 16.5x. This tells us the average stock is still fairly priced and that some segments of the market have further room for improvement. We also recognize domestic equity markets have essentially gone nowhere for two years (the Russell 2000 is actually still down over two years) despite the recently rally. This period of digestion could augur well for returns going forward, even if the scalding hot pace of recent months cools off.

Amidst a backdrop of confounding crosscurrents, heightened volatility and financial media myopia, we think it is important as ever to remember we are investing for the long term. We all frequently hear from investors, strategists and media personalities that are negative one day and positive the next. These distractions are only likely to intensify as we enter a presidential election year. Though we constantly adapt our view to new information and data, we think it’s important to step back and focus on the backbone of our investment philosophy – buying stakes in good businesses at reasonable prices. We remain confident this approach will yield solid results for our clients over time. Thank you for your trust and we wish you all the best in 2024!



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