UPLAND
Capital Management LLC

2023 YEAR-END SUMMARY

Global stock and bond markets saw powerful ‘everything rallies’ coming into year-end, ignited when the Federal Reserve unexpectedly reversed its cautious policy outlook and signaled that *disinflationary trends were sufficient to project a shift to monetary easing in 2024*. Most major asset classes posted double-digit gains in the year’s final quarter and, importantly, market breadth broadened. In the U.S., the dramatic rebound in the stocks of the seven largest U.S. companies by market capitalization - concentrated in technology and communication - led the U.S. equity market’s extraordinary gain. Without these seven largest companies, the broader index would have risen just 12%; the Tech sector would have returned just 15% rather than 50%; the Communication Services sector, 7% vs 50%; and the Consumer Discretionary sector 6% versus 33%, according to FactSet. Gains were mainly driven by multiple expansion, as earnings growth was flat or negative across most regions. For the full year, U.S. large-cap growth stocks led all asset classes, gaining more than 40% and outperforming large-value stocks by a wide margin. Less cyclical sectors, including energy, consumer staples and utilities, ended the year with losses. The drop in commodity prices during 2023, highlighted by the declines in oil and gas prices, contributed to significant disinflation. Commodities were the only major asset category to decline. The Bloomberg Commodity Index fell 4.6% in the final quarter and ended the year down 7.9%. U.S. and international developed regions, which have experienced decelerating earnings growth since 2021, finally showed signs of stabilizing. Emerging markets remained laggards, with double digit earnings contraction on a year-over-year basis. On expectations for future Fed easing, yields on U.S. 10-year Treasury bonds, which had risen above 5% in the year’s third quarter, turned sharply lower. Nominal yields on 10-year Treasury notes ended the year at 3.88%, exactly where they began the year, giving little hint of the year’s highly volatile journey. Credit-sensitive corners of the bond market performed strongly, as the economy avoided recession; high-yield bonds gained 13.5%. The U.S. dollar weakened some in the year’s final quarter as yields declined. Despite this, the Dollar remained over-valued according to purchasing power metrics with its major trading partners, particularly the Japanese yen.

COMMENT:

TWILIGHT ZONE

This time last year, 85% of economists, in one Financial Times poll, predicted a recession in 2023 — and that was an optimistic take compared to the 100% probability of a recession forecast two months earlier. In March, Federal Reserve Chair Jerome Powell, drawing upon the work of his highly able staff, expressed fear that bringing down the rate of inflation would cost millions of American jobs. And yet none of this has happened. Rather than contracting as most economists anticipated, the U.S. economy expanded in every quarter of 2023, culminating in a robust annualized + 4.9% in the third quarter of GDP. Forecasters now expect average annual real GDP to have increased 2.4% in 2023 and expect +1.7% in 2024, slowing but avoiding a recession.

The world has likely entered the new year in a twilight zone between a slowdown, possible recession, and recovery – where nothing is likely to be quite what it seems. As a result of the Fed's policy shift, markets began 2024 with momentum and the prospect of easier financial conditions. That said, positive surprises for the economy, disinflation, and Fed cuts may be more difficult with so much good news priced in. 2023 saw U.S. companies suffer through an earnings recession – with three consecutive quarters of declining year-over-year earnings growth. According to FactSet, the earnings recession ended in the third quarter. With high interest rates expected to keep multiples in check, *earnings growth is likely to be a key driver of regional returns*. Year-over-year earnings for the S&P 500 companies are on pace to grow about 4% in the year's final quarter. This follows earnings growth of about 8% in 2022 and double-digit growth in 2021. After dropping from record-high levels, profit margins stabilized toward the end of 2023, leading to expectations for a strong earnings rebound in 2024. *Analysts are currently forecasting 2024 S&P 500 Index earnings to rise about 12% from 2023.* Earnings grew by less than 2% in 2023, while GDP growth was constantly surprising to the upside. With margins still at the upper end of their historical range and signs of diminishing pricing power, the ability of companies to maintain or expand margins will be key to the outlook. While the global monetary tightening cycle appears to be over, the pace and magnitude of easing remains uncertain. China remains the outlier as it struggles to reaccelerate growth after its Covid slump. Global growth is forecast to slow from 3.5 percent in 2022 to 3.0 percent in 2023 and 2.9 percent in 2024. In advanced economies, the expected slowdown is from 2.6 percent in 2022 to 1.5 percent in 2023 and 1.4 percent in 2024, amid stronger-than-expected US momentum but weaker-than-expected growth in the euro area. *The steady decline in year-over -year inflation rates slowed in recent months. Housing services, in particular, slowed much less than market expectations and disinflation in other services stalled*. Absent a greater deterioration in economic activity, there is a risk inflation will remain above the Fed's 2% target. Given the cyclical outlook for the next 6 to 12 months, bond market gains are likely to be sustained but not extended. Increased Treasury bond issuance may also lead to a less inverted (steepening) yield curve.

While improvements in market breadth suggest a more inclusive rally could be on the horizon, a sustained rebound would require significant economic growth and liquidity – risks to both remain substantial. While consumer spending remains robust, its drivers are fading. Household cash balances are being drawn down; consumer credit conditions have deteriorated; and delinquencies (mortgage, auto, credit cards) are rising. And while stabilizing margins among the S&P 500 have improved the earnings outlook, topline growth is flagging. Given the onerous mix of a Fed-induced rally and a still weakening economy, we believe a lot of good news is now priced into equities. The forward 12-month P/E ratio for the S&P 500 is 19.5. This P/E ratio is above the 5-year average (18.9) and above the 10-year average (17.6). Exuberant markets have already priced in as many as six rate cuts, three more than suggested in the Fed's most recent 'dot plot release,' which shows the opinions of its Open Market Committee Members. A recent Conference Board forecast, a leading corporate research organization, included, *"We anticipate a tepid start to 2024. While the prospects for a soft landing have risen, we continue to believe that volatility awaits the US economy in this year. We forecast two quarters of slightly negative GDP growth in Q2 and Q3 2024 that will be broadly felt across the economy."* Of course, an important lesson of 2023 is that markets can defy apparent weak fundamentals for much longer than expected, especially in markets with excess liquidity. It is also important to note that Index valuations appear less full once mega-cap technology stocks are excluded. With interest rates likely to decline and substantial amounts of cash on the sidelines, the markets will also be subject to a tide of liquidity, sentiment, and momentum.

A redeployment of cash and declining rates could sustain current market momentum, but slower economic growth provides a cautious equity market backdrop. We remain near neutral equity weightings, favoring equal weighted sector investments offering broad diversification and more attractive fundamentals. We continue to prefer hedged equity proxies for large-cap exposure. While Fed interest rate cuts may come more slowly over the coming months, the return on cash and ultra-short bond proxies appear set to decline, so we continue to extend the duration of our bond investments.