# ICR® 4th Quarter Newsletter – January 2024

Markets roared higher in the fourth quarter as the Federal Reserve indicated that it will likely stop raising interest rates and even begin to lower them in 2024. The S&P 500 rallied another 11.2% in the quarter, finishing up over 24% for the year. Small cap stocks, which had been basically flat for the year, gained 13.6% in the fourth quarter alone. The real estate sector, which would benefit from lower interest rates, led the way with an 18.8% gain, while energy was the only negative sector, posting a 6.9% loss.

Foreign markets also rallied, with the MSCI EAFE Foreign Developed Markets index gaining just over 10% in the fourth quarter. The MSCI Emerging Markets index was held back by its large China component as the Chinese market posted a 4.6% loss in the fourth quarter. Despite that, the broader emerging markets index still posted a 7.5% gain as most of the other countries performed well.

Bond yields tumbled on expectations that the Federal Reserve may begin lowering rates sooner rather than later. After starting the quarter at 4.58%, the ten-year Treasury yield briefly touched 5% before falling all the way to 3.88% in the span of ten weeks. Gold also benefited from revised Fed expectations, hitting an all-time high of $2,135/oz. before settling in around $2,072/oz.

It's easy to criticize Jerome Powell and the Federal Reserve, but let's recap what has happened in the last 18 months (since June 2022):

- 12-month CPI readings have fallen from 9.1% to 3.4%
- The unemployment rate is basically unchanged (3.7%, up from 3.6%)
- Annual growth in real GDP has increased from -0.6% to 4.9% in the third quarter of 2023

Does the Fed deserve all the credit for this? No, of course not. But, for all the complaints about how they were too late in starting the inflation fight and then possibly raised rates too high too fast, so far, their approach is looking pretty good. Critics of the Fed will say the story isn't finished yet and we're still diving head-first into a nasty recession. But the story is never finished since everything that has happened in the economy will impact everything that is yet to happen. It is human nature to prefer binary outcomes and judgments. Did they succeed or fail? The answer is rarely that simple.

First, there is some question as to how much credit that Fed deserves and how much of the inflationary pressure was truly transitory all along and would have eased with or without Fed action. A couple of years ago the Fed was largely being mocked for calling inflation transitory and not combatting it sooner. Now, there are signs that Covid-related factors like disrupted supply chains and a complete shutdown of the huge service sector of the economy were likely responsible for a large component of the inflation and those pressures have now mostly abated. Whether it should now be labeled "transitory" depends a lot on one's timeframe for evaluating the inflation we've experienced. It sure didn't feel transitory at the time when month after month we saw a higher CPI print and it felt like there was no end in sight. But, if you put it into a historical perspective (assuming it doesn't flare back up), this recent bout of inflation looks like a blip.

That isn't to say that inflation hasn't had a negative impact, because it certainly has. And, even though the rate of inflation has slowed tremendously, prices are still far above pre-Covid levels and probably won't actually decrease (other than in certain anomalous areas like used cars). That is, we're not likely to see actual deflation – and if we did, it would probably be due to a recession. Speaking of a recession, are we out of the woods yet? A recent survey of economists showed that over three-quarters of them believe there is less than a 50% chance of a recession this year. But economists have been known to be wrong on occasion. For example, at the end of 2022, there were headlines in Bloomberg like: "Economists Place 70% Chance for US Recession in 2023." So, who knows?

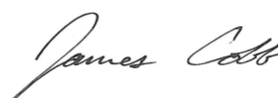
What we do know is that, to this point, things have played out better than most expected. Can the Fed manage to bring interest rates back down before the economy slows but also wait long enough to ensure that the inflation rate doesn't increase again (if the Fed Funds Rate is even a meaningful lever for inflation)? It's probably too much to ask them to thread that needle perfectly, so it's reasonable to expect that either inflation ticks back up or we experience an economic slowdown. The good news is that we're starting from a relatively strong position with a low unemployment rate and an inflation rate that is at least tolerable.

In terms of investment implications, the Fed potentially lowering interest rates would bring the yields on money market accounts down. Investors have been enjoying 5% yields on their cash, but should probably expect that to gradually decline. That could cause investors to re-allocate that money to other asset classes like stocks and bonds, but it also wouldn't be surprising if most people just do nothing and accept the lower return going forward. The rally in stocks in the fourth quarter was largely due to the assumption that the Fed would be lowering rates multiple times in 2024. If that doesn't happen – or if other factors (geopolitical, for example) get in the way – markets could react poorly. But, if expectations are basically in line with reality, then markets will likely be guided by actual corporate fundamentals and whether companies can adjust to a U.S. consumer that may be slowing their spending relative to recent years.

Thank you for allowing us to help you achieve your financial goals. As we enter another year that promises to take plenty of twists and turns (we hadn't even mentioned that it's an election year), please don't hesitate to call or email with any questions or thoughts you may have.

Sincerely,

James A. Heine



James L. Cobb

**Market Report (as of 12/31/23)**

| **Index** | **2023 (%)** | **3-Year Annualized (%)** | **5-Year Annualized (%)** |
|---|---|---|---|
| S&P 500 | 24.2 | 8.3 | 13.7 |
| Dow Jones Industrial Average | 13.7 | 7.2 | 10.1 |
| U.S. Aggregate Bond Index | 5.5 | -3.3 | 1.1 |
| MSCI EAFE (Foreign Index) | 15.0 | 1.4 | 5.4 |

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