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Vibecession

January 2024

Summary

In 2022, interest rates hit levels not seen in 20 years and the conventional wisdom on Wall Street called for a recession to arrive in 2023. As a result, the stock market realized a bear market drawdown of 25%. However, the economy proved resilient, and the employment situation remained strong. So far, the economy is not in a recession, and the negative market returns from 2022 were almost fully recovered in 2023. Even though returns for the year were strong, stocks have not yet reached new highs and are still trading at the same levels they reached in late 2021.

For balanced portfolios, bonds finally contributed positive returns after back-to-back losses. Bond allocations are normally the stable part of a portfolio, but they have not fit that mold in recent years.

This period has been deemed by some to be a "vibecession," due to the widespread pessimism that does not match up with the relatively strong economic situation. Whether from fallout of the first bout of inflation in decades, the divided political climate, or some other factor, it just felt like things were bad. Even with falling inflation and after a positive 2023, sentiment is still relatively sour.

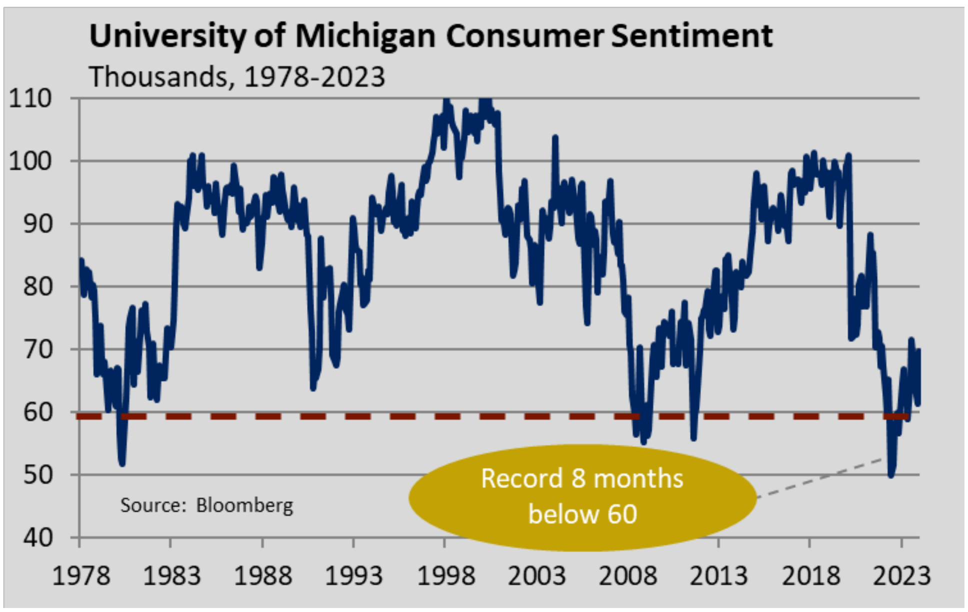
In considering the outlook for 2024, there are several aspects of the economy and financial markets that are important to consider:

- **Consumer sentiment was lower in 2022 than the great financial crisis in 2008,** setting the stage for a strong 2023 and beyond.
- **The Fed (likely) finished raising rates this cycle –** the 11 interest rate hikes since early 2022 was the fastest pace of increases since the 1970s. Easier monetary policy is on the horizon.
- **The economy has been quite resilient** – economic growth and employment remain solid despite aggressive monetary tightening. The presumed slowdown should be mild, but indicators need to confirm that trend in 2024.
- **Inflation is trending toward the Fed's target** – after surging to 7%, PCE inflation is almost back to the Fed target of 2%.
- **The strongest year in the presidential election cycle generated robust returns for U.S. stocks.** The second strongest year in the four-year cycle is the election year, which posted only two loss years out of the last 18.

The Vibecession

One of the main characteristics of the past two years was that investors felt dismal about the future. A nasty sequence of events kept the University of Michigan Consumer Sentiment Index below a reading of 60 for a record eight straight months. Even during the financial crisis in 2008, sentiment was not as persistently low. The recessions in 1980, 1982, 1991, 2001, 2008 and 2020 were all perceived by consumers to be better periods than 2022-2023.

The source(s) of the negative vibes may be numerous. The pandemic created an anxious atmosphere, which was quickly followed by the worst inflation since the 1970s. Mortgage rates reached 8%, U.S. debt levels continue to rise, and the political environment is more polarized than ever. Some commentators have deemed this period a “vibecession,” due to the widespread pessimism that does not match up with the relatively strong economic situation. Case in point: this past spring, unemployment reached the lowest level since the 1960s. (See more data on economic growth, unemployment, etc. on pages 4-5).



Interestingly, consumer sentiment can act as a contrary indicator at times. As Warren Buffett famously noted, “be fearful when others are greedy and be greedy only when others are fearful.” When the environment seems perfectly lined up for success, there is a much greater chance of disappointment. When things seem to be grim, there is plenty of room for conditions to be better than anticipated.

Discussion & Positioning

The battle between the Federal Reserve and inflation is not entirely over, but inflation seems to be returning to normal levels. The Fed raised interest rates 11 times over the past two years, the fastest pace of rate hikes since the 1970s. The challenge of high interest rates is exemplified by 30-year mortgage rates, which reached 7.8% in October, the highest rate since 2000. With high borrowing costs impacting families, businesses and the government, many investors expected the economy to slow meaningfully and enter a recession.

Despite those expectations, economic growth and employment have been quite resilient. Inflation has receded, and, if the current trend continues, should allow the Fed to ease monetary policy in 2024. At the most recent news conference on December 13, Fed Chairman Jerome Powell summarized the Fed's approach to raising rates over the past few years and acknowledged the change in mindset from fiscal tightening to accommodation:

> *"When we started out, right, we said the first question is how fast to move, and we moved very fast. The second question is, you know, really, how high to raise the policy rate, and that's really the question that we're still on here.... [T]he other question, the question of when will it become appropriate to begin dialing back the amount of policy restraint in place, that begins to come into view, and is clearly a topic of discussion out in the world and also a discussion for us at our meeting today."*

Easier monetary policy is good news, but, even if the Fed does reverse course in 2024, the impact of higher rates will continue. GDP growth will likely remain slow, and unemployment will likely increase.

At this point, the potential for a soft landing has increased. The stock market has embraced that narrative, as demonstrated by the strength of both stocks and bonds in November and December (the S&P 500 was up 14% over two months, and bonds were up 8%). However, it will take time to determine if a soft landing was indeed achieved or whether the recession was just delayed.

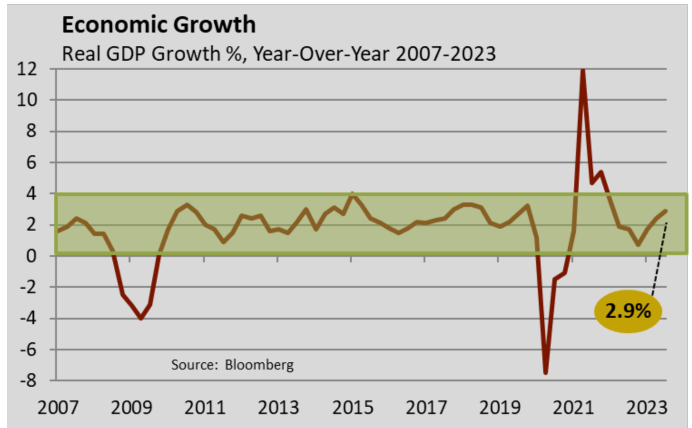
Client portfolios remain overweight to equity allocations and have been so for almost a year. The momentum of the stock market should continue into 2024, and, absent a recession, bear markets (drawdowns over 20%) typically do not occur within two years of each other. Investors are still relatively pessimistic, providing plenty of opportunity for the environment to improve. There are some risks early in the year as the Fed will continue to wrestle with inflation, and the market could swing a bit as the degree of the economic slowdown becomes clearer.

As discussed in the September commentary, the cyclical nature of markets was disrupted by the pandemic but remains an important influence. It was noted that seasonal tendencies continue, "October is the most frequent month when bear markets end and bull markets begin. Of the 22 bear markets since 1950, 10 have ended in either September or October." Two years in a row, October marked the low point of the drawdown. The 2022 bear market ended in October 2022, triggering a nine-month rally. The 10% drawdown in 2023 ended in October 2023, followed by a 14% year-end rally.

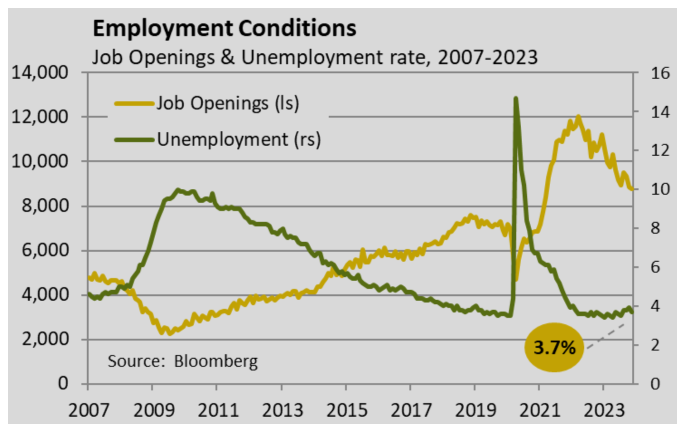
The first half of an election year can be bumpy. Anxiety about the wrong candidate winning the election is shared across both parties. As the election nears, it is common for the stock market to rally in response to the certainty of either answer. For financial markets, stability comes from knowing what government will be in power and the likely rules of the game.

Economic Conditions Remain Favorable

After significant changes in inflation, monetary policy and interest rates, the economy seems to be normalizing. Given the roller coaster of monetary and fiscal stimulus, the economy has been quite resilient so far.

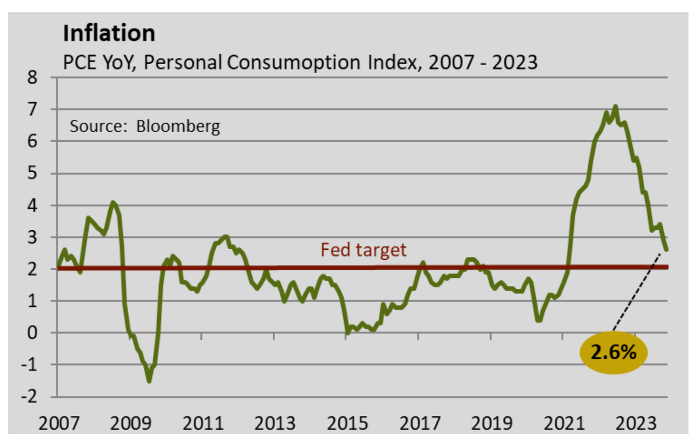


Real (adjusted for inflation) economic growth has settled back to a 2.9% year-over-year growth rate. GDP is the inflation-adjusted value of the goods and services produced by labor and property in the United States. The economy is still growing at a modest pace even after adjusting for the post-pandemic spike in inflation.



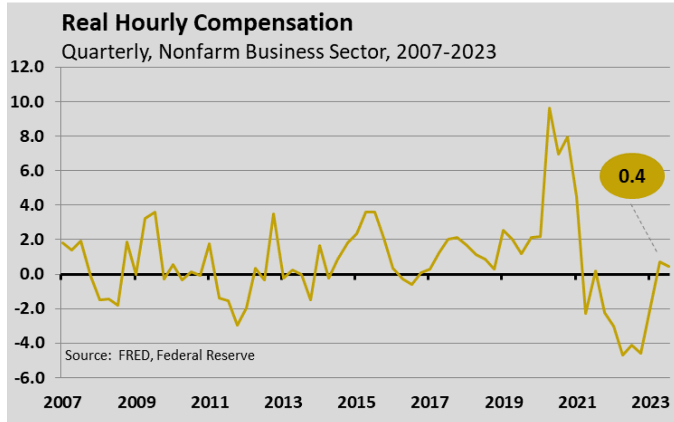
The unemployment rate is very low, currently at 3.7%, and has remained at 4% or lower for over two years. In April 2023, the unemployment rate reached 3.4%, the lowest rate since the 1960s. Further increases to the measure are expected – especially since employment is typically a lagging indicator – but increases would be in line with historical norms.

Interestingly, job openings have remained quite strong. This indicator demonstrates the labor market is still robust and there is plenty of demand for jobs. While it is easier to eliminate a job posting than an active employee, it is an indicator of strength. Active job openings, while declining from their peak, remain well above levels achieved before the pandemic.



Inflation surged after the pandemic in 2021 and remained high in 2022. After reaching a peak of 7.1% in mid-2021, inflation fell to 2.6% in late 2023. As mentioned in the 2023 Outlook commentary, inflationary spikes tend to be symmetrical, and the most recent case held true to form. While more improvement is needed to reach the Federal Reserve target of 2%, fears of long-term inflationary pressures have subsided.

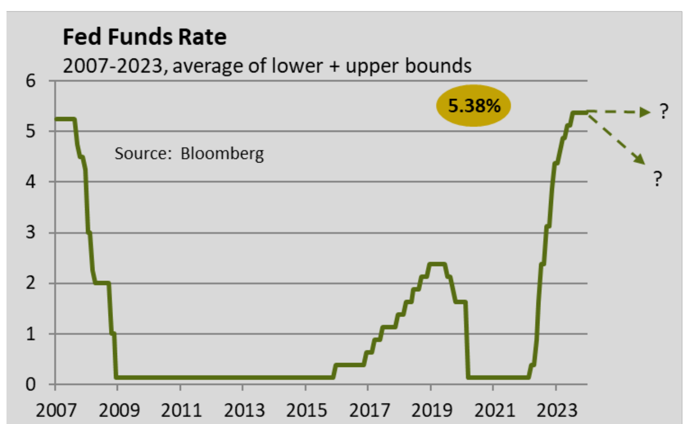
The improvement in inflation can also be seen in real wages. After adjusting for inflation, wage growth is now positive for the first time since mid-2021. While nominal wages improved over the last few years, the after-inflation measure did not keep pace. Real wage growth is obviously important to households but also has a significant impact on workers' perception of their wealth and situation. Improved sentiment about wages and income should reduce the risk of a downward economic spiral.



In recessionary periods, corporate profits tend to decline. Since profitability is a key factor in valuation, stock prices tend to decline in such periods as well. S&P 500 operating margin saw a decline over the past two years, but that was after a strong increase during the pandemic recovery. Margins seem to have stabilized near their pre-pandemic peak of 13-14%.

As a result of the improved inflation data, the Fed appears to have stopped raising interest rates. After 11 increases over the past two years, which was the fastest pace of rate hikes since the 1970s, the current Fed funds target is 5.25 to 5.5%.

High interest rates are a challenge for the economic environment. Consumers and businesses are less likely to borrow funds to invest in new projects or buy a new property when the cost of debt is high. If inflation continues to slow, the Fed should be able to cut interest rates in 2024. Job openings will likely continue to decline, and unemployment will likely rise, but a more friendly Fed should limit the damage from a slowing economy.



Presidential Election Cycle

The election tends to impact financial markets but not in the way that most investors expect. The tendencies of the four-year election cycle are much more important to financial markets than the specific candidates or issues. While the election is obviously significant, the President (and Congress) are not engines of the economy or the stock market. It is common to think that a certain candidate or party will be better for the economy, and those expectations are typically incorrect. A common belief is that Republicans are typically more pro-growth and therefore create better economic and market conditions. History since 1948 says otherwise, -- the average U.S. stock market return under Republicans was 7.1% while returns under Democrats was 9.8%.

Presidential Election Cycle

1948-2022

	Post-election	Mid-term	Pre-election	Election year
Percent positive	63%	58%	90%	83%
Years of losses over -5%	7	7	0	2
Median gain	9.1%	1.1%	18.9%	10.7%

Source: Bloomberg, Ned Davis Research

What is important to the stock market is the four-year election cycle, regardless of party. The third year (pre-presidential election year) in the cycle is typically the strongest, with a median gain of 18.9%. It is no secret that politicians want to be re-elected, and fiscal spending is tightly connected to that desire. Most government spending occurs in this year as those officials currently in power want to take action (i.e. spend money) with enough time for results to be demonstrated before the election in the following year.

The election year is also a solid year in the four-year cycle, but returns are typically weighted to the back half of the year. In the first half, uncertainty about the looming election weighs on financial markets. All investors are nervous about the “other side” winning the election and what that would entail. Businesses may sit on the sideline until they know which party will be in power, and thus what the regulatory and tax environment will look like. Often the stock market begins to rally when the election outcome is known (in some years, that is well ahead of election day). A bumpy first half often leads to a second half rally (see chart, next page).

The first year in the cycle (post-election year) is characterized by optimism with the new (or revised) makeup in Washington. The uncertainty of the election is over, and finally the President and Congress have clear marching orders and will move the country forward. Investors are hopeful that given a little time, the legislature will act.

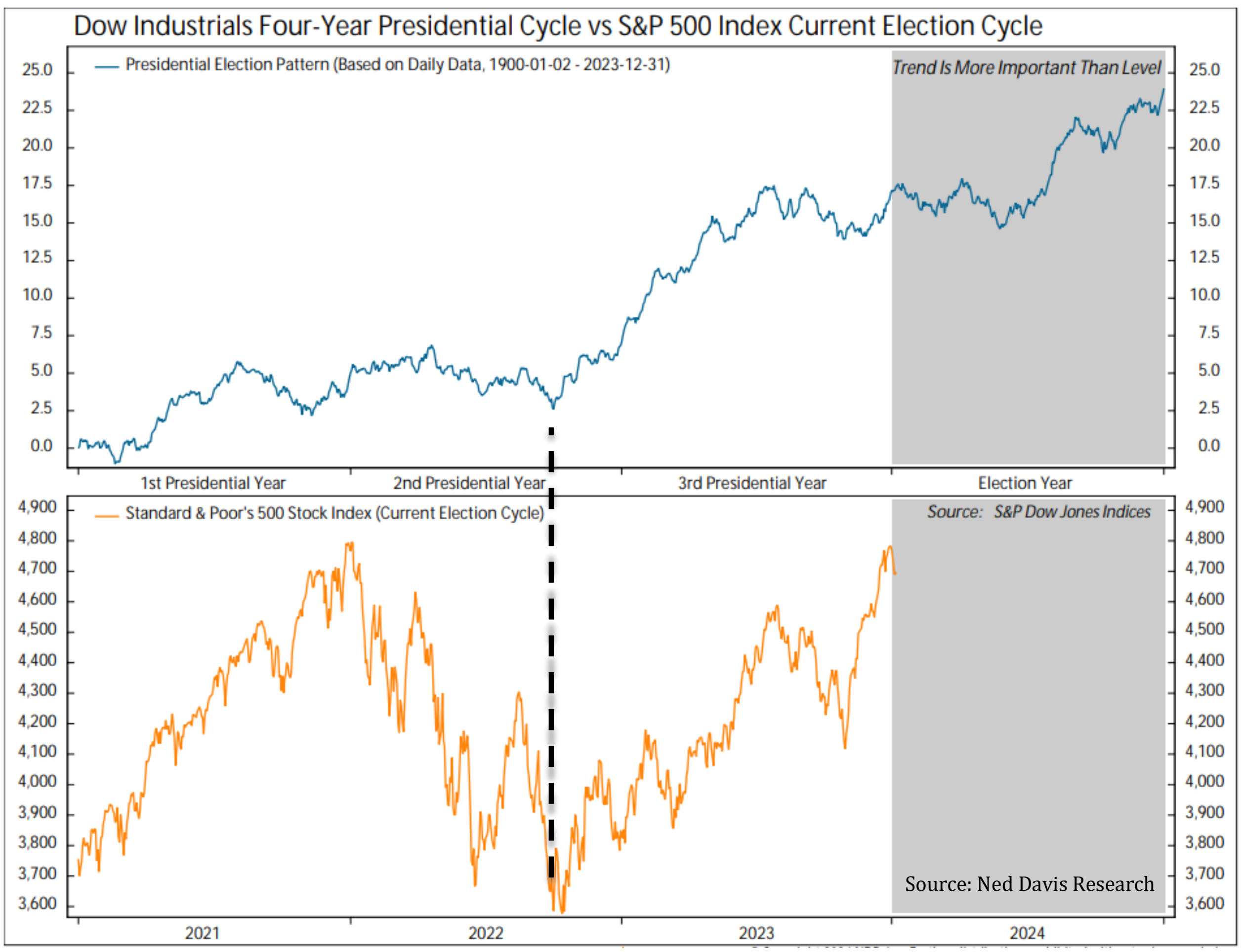
The mid-term year is the most volatile year in the cycle. The optimism from the election wears off, and lack of action on political promises turns into disappointment. In 8 of the last 19 cycles, U.S. stocks were negative for the mid-term year, and median gains barely exceed 1%. However, a little shock from the disappointment and a bad mid-term year provides incentive to make progress… and the whole cycle kicks off again.

A visual of the historical four-year cycle (blue line) and the current cycle (orange line) is shown below. Each cycle is different, and each year is unique, but the historical tendency is important to consider. This is one indicator to be considered amongst many when making investment decisions, and the trend is more important than exact dates and/or returns.

The current cycle lines up relatively well with the longer-term history. Stock market returns in 2021 were strong following the pandemic recovery. The 27% return was clearly higher than the median for the first presidential year but was in line with the prior three elections, all of which generated 19% or higher for U.S. stocks.

The midterm year (2022) followed the historical tendency for weakness, realizing an 18% loss for the year. The stock market bottomed in October 2022 (the most common month for bear markets to end and bull markets to begin). October of the midterm is typically the turning point, kicking off the strongest 18 months in the four-year cycle. Congressional action this cycle included the CHIPS Act and the poorly named Inflation Reduction Act, both of which include meaningful spending on infrastructure items.

Right on cue, midterm weakness and fiscal stimulus lead to a 2023 stock market rally. A strong rally initiated from the midterm bottom and was followed by a late summer correction. After a fourth quarter rally, U.S. stocks finished the year up 26%.



Asset Classes & Investment Returns

Returns from the past two calendar years were polar opposites, and most asset classes rebounded nicely in 2023. In 2022, recession worries were significant and most major investment options saw double-digit losses. At the same time, the worst bond losses on record posed a significant challenge to the normal "60-40" portfolio. In 2023, U.S. stocks recovered nicely, posting a 26% return for the year while international stocks were up 18%.

Notable, however, is the fact that neither U.S. nor international stocks have hit new highs in over two years. The highs set in late 2021 and the first few days of 2022 have not yet been breached (see chart, page 1). The S&P 500 hit 4797 on the first trading day in 2022, fell to 3577 in October 2022, and has been winding its way higher to finish 2023 at 4770 (still slightly below the level from two years ago).

2023		2022	
S&P 500	+26.3%	Commodities	+20.6%
All Cap World	+22.8%	Dow Jones	-6.9%
International	+18.2%	High Yield Bond	-11.2%
Small Caps	+16.9%	Invest Grade Bonds	-13.0%
Dow Jones	+16.2%	International	-14.5%
High Yield Bond	+13.4%	All Cap World	-18.0%
Emerging	+9.8%	S&P 500	-18.1%
Invest Grade Bonds	+5.5%	Emerging	-20.1%
Long-term Treasuries	+3.1%	Small Caps	-20.4%
Commodities	-4.3%	Long-term Treasuries	-29.3%

Source: Bloomberg

The past two years have been quite bumpy with both stocks and bonds seeing numerous swings in returns. While stocks were up in the first half of the year, a 10% correction occurred in the late summer and fall (the most common period for stock market volatility). By late October, U.S. stocks were only up 7% for the year. A strong rally in the last two months generated most of the gains for the year.

A similar trend occurred in the bond market. Bonds saw losses for the first ten months of the year, posting a loss of 3.4% through mid-October. Interest rates rose from January to October, and the 10-year Treasury bond saw yields of 5% late in the year. Since bond prices and interest rates are inversely correlated, higher rates led to lower bond returns. However, bonds turned the corner in November and December. Interest rates fell significantly, and the yield on a 10-year Treasury bond fell from 5.0% to 3.9% by year end. As a result, bonds saw great returns in the last two months of the year, moving from a 3.4% loss to a 5.5% gain. Such big swings in bond returns are not normal, and they exemplify the change in outlook for both inflation and economic growth for 2024.

Summary of Current Positioning

Most clients are currently overweight to equity allocations (below maximum equity allocation but above their neutral position). After mostly shunning bonds in 2022, they were added back to client portfolios throughout the year. The main risks from here appear to be an unexpected reacceleration in inflation or a geopolitical event. While current equity allocations are appropriate for now, the next move would likely be a modest reduction in equities.

If you have questions on the investment environment or your portfolio, please call us at 734-769-7727. To find an electronic copy of this document and other recent commentaries, please visit our website at www.risadvisory.com.

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These data are for illustrative purposes only and is not indicative of any investment or strategy result. The S&P 500 is an index of 500 stocks representing major U.S. industry sectors. The Dow Jones Industrial Average is an index made up of 30 large U.S. company stocks. World stocks (the All Cap World index) are represented by the MSCI ACWI index and is designed to measure the equity market performance of developed and emerging markets. The MSCI ACWI consists of 45 country indices comprising 24 developed and 21 emerging market country indices. Investment grade and broad market bonds are represented by the Barclays Aggregate Bond Index includes most U.S. traded investment grade bonds, including Treasury securities, government agency bonds, mortgage-backed bonds, corporate bonds, and a small amount of foreign bonds traded in U.S. Developed Int'l is represented by MSCI EAFE Index, which is an index of major international equity markets as represented by 21 major MSCI indexes from Europe, Australia and Southeast Asia. Emerging Markets is represented by MSCI Emerging Markets Index, which is an index that is designed to measure equity market performance in global emerging markets (over 20 countries including Brazil, Russia, India, and China). Treasuries are represented by the Barclays Capital U.S. 7-10 Year Treasury index, which measures the performance of U.S. Treasury securities that have a remaining maturity of at least seven years and less than 10 years. Long-term Treasuries are represented by the Bloomberg Barclays U.S. Long Treasury Bond Index which includes fixed income securities issued by the U.S. Treasury with maturities greater than 10 years.

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