*The markets are telling us that the risk of recession has receded,
inflation is under control, unemployment remains low, and the US economy is solid.
That should make 2024 hospitable to stock investors.*

THE FUTURE

At the beginning of 2023, 80% of forecasters surveyed by the *Wall Street Journal* predicted a recession in 2023. This, in turn, spelled a bear market in stocks. And yet here we are with 2023 in the rearview mirror, economic growth solid, and the S&P 500 up 26.3% for the year. (I guess that's why they call it "the future.")

So, what happened? First, coming out of the (very brief) pandemic recession, inflation in the US surged to a peak of 9.1%, a level not seen in four decades. The last such outbreak came in the early 1980s when inflation reached 16%. In response, Fed Chair Paul Volcker jacked up short-term interest rates to almost 19% (!), driving the US economy into recession, the US unemployment rate to 11%, and inflation down to 4%. This, then, was the template many forecasters looked to: You beat high inflation with a recession and high unemployment.

HOW TO FIGHT INFLATION

The basic theory of why inflation rises is that too many dollars end up chasing too few goods and services. That is, when demand outstrips supply, prices rise. Volcker's solution to inflation was to attack the demand side of the equation. That is, reduce the high level of wage growth that characterized the late '70s and early '80s and thereby reduce consumer spending. This was most readily done by raising interest rates and inducing a recession. And it worked, however painfully.

The problem with using the Volcker template in 2023 was that the demand/supply imbalance that spurred higher inflation coming out of the pandemic was, at least in part, a problem of supply. With global supply chains snarled by lockdowns, many types of goods production all but ground to a halt, sharply curtailing supply.

TEAM TRANSITORY

At the time (and to this day), a debate has raged in the economic community over which kind of inflation the US suffered coming out of the pandemic: was it driven by demand or supply? Famed economist and former Secretary of the Treasury, Larry Summers, loudly proclaimed that it was demand-driven, in large part by the huge fiscal stimulus Congress authorized to stimulate the sagging economy. He argued that unemployment would need to be driven up sharply and for a long time to bring down inflation (which would entail a recession).

New York Times columnist and Nobel Prize-winning economist, Paul Krugman, was the champion of "Team Transitory," who argued that the supply-chain snarls that caused inflation were transitory and would work themselves out over time.

As inflation has plummeted—and by some measures is now at or below the Fed's target of 2%—while unemployment remains near historic lows and the economy is solid, it would appear that Summers was wrong and Team Transitory was right in maintaining that high unemployment wasn't required to tame inflation.

THE FED PIVOT

As the Fed observed the benign developments of inflation falling without unemployment rising—also known as a "soft landing"—its focus shifted away from fighting inflation and toward the negative effects on employment of keeping rates too high for too long. As a result, the Fed's messaging increasingly suggested rate hikes were likely in the rearview mirror and that rate ***cuts*** were now on the horizon.

As we've underlined repeatedly over the years, the Fed raising interest rates historically has been ***<u>the</u>*** primary threat to the stock market. It has because the Fed raising interest rates has, more often than not, tipped the US economy into recession. With the Fed's pivot away from raising rates and toward cutting them, the consensus view that a recession was imminent began to waver.

BAD BREADTH

For the first nine months of 2023, the stock market's headline returns were driven largely by the so-called, "Magnificent Seven," namely, Apple, Microsoft, Amazon, Tesla, Nvidia, Alphabet (Google) and Meta (Facebook). And because the S&P 500 is a capitalization-weighted index, the biggest names by market cap (# shares x price/share) have the biggest impact on the overall index returns.

As it happened in 2023, the very large Magnificent Seven stocks accounted for around 30% of the total index. And as it also happened, they all went through the roof early in the year in part due to the boom in AI technology. These skyrocketing behemoths pulled the overall index returns up with them, masking the fact that the majority of the S&P's stocks lagged the index returns for the first nine months.

This "bad breadth" indicated the stock market wasn't as healthy as its headline returns suggested. And, indeed, part of the appeal of the Mag Seven—apart from their AI exposure—is that they represent companies that are a) toweringly dominant in their industries, b) very steady long-term growers with c) vast cash hordes and bullet-proof balance sheets. These features made them attractive as being more durable in a recession, predictions of which had dominated the consensus.

SEA CHANGE

With the Fed pivot indicating that rate hikes were in the past, a sea-change took hold across the markets in the fourth quarter, as investors lowered the odds of a coming recession. The bond market responded with falling interest rates/rising bond prices as the yield on the 10-year US Treasury Note fell from a hair over 5% to a hair under 4%. Stocks rose sharply with the S&P 500 gaining 11.7% for the quarter.

The spread between the interest rates paid by lower quality bonds and those of high quality bonds narrowed sharply, indicating a reduction in perceived default risk. The price-to-earnings or P/E multiple on stocks rose as future corporate earnings streams were judged more reliable. Bank stocks, which had been pummeled following the failure of Silicon Valley Bank *et al*, rallied sharply. Homebuilder stocks, which had swooned under higher mortgage rates, soared as rates fell. And, most importantly, market breadth improved dramatically as investors' appetite for smaller and/or more cyclical equities dramatically increased.

LISTENING

The narrow breadth of the stock market in the first nine months of 2023 as well as the strength of the Magnificent Seven was, in our opinion, a sign that investors were nervous about a coming recession and taking refuge in the biggest and safest stocks.

With the fourth-quarter sea change described above, we believe the markets are telling us that the risks of a US recession have receded, inflation is under control, the employment picture remains strong (but not too), and, generally, that the US consumer and the US economy are in good shape. That should make 2024 hospitable to stock investors.

Keep in mind that the strong gains made in 2023 just barely pulled the S&P 500 above the previous high reached in January of 2022. So, it was a catch-up year. While we don't expect 2024 to produce as dramatic returns, we do expect returns to be positive and more broad based.

That said, with two wars raging in Ukraine and Gaza, geopolitical risks remain a wild card.

A NOTE ON BREADTH

With stock market returns monopolized by a handful of mega-cap stocks, and thus market breadth extremely narrow for most of 2023, active managers—that is, non-indexing stock portfolio managers—in general had an uphill climb to keep up with benchmark returns. (We explained this dynamic in detail in our July Market Outlook.)

For 2023 our Arjuna 350 US stock strategy returned 23.6% vs. the S&P 500's 26.3%. Our Arjuna Global Impact stock strategy returned 21.1% vs. the MSCI World return of 23.8%. We're delighted with these absolute returns for the year. And while we attempt to best our benchmarks, there are years when the playing field is simply tilted against us structurally. 2023 was such a year.

It's worth noting that in the fourth quarter of 2023, as market breadth improved dramatically and the broader market began to catch up to the Mag Seven, Arjuna's relative performance picked up sharply, as we expected. For 4Q23, Arjuna 350 was up 12.1% vs. the S&P 500 11.7% while Arjuna Global was up 12.6% vs. the MSCI World's 11.4%.

Farnum Brown
Chief Strategist

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