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MARKET SIGHT LINES

2023 Signposts for Finding Balance

By Michael O'Keeffe, *Chief Investment Officer*

My team and I are developing our final outlook for 2024, which we plan to publish the first week of January. Part of that process involves looking back at 2023 to assess how things have unfolded. We started the year with a focus on finding balance, defining several signposts for progress.

In this week's Sight|Lines we review our signposts for this year as we moved toward finding balance.

THE TAKEAWAY: WE MADE GOOD PROGRESS ON SIGNPOSTS BUT WANT TO SEE MORE.

Our signposts for finding balance in 2023 focused on numerous factors. In summary:

- China reopened as we started 2023, but supply chains remained impacted, and the country faced headwinds to its property sector and experienced an overall disappointing year for the economy.
- Inflation has been in focus, and we've seen progress on drivers of inflation, including improved shelter costs, slowing wage growth, and a labor market closer to equilibrium. We'd like to see more progress.
- We started the year with Federal Reserve (Fed) and market forecasts for future Fed policy misaligned, and while these were, for a time, better aligned, the Fed remains more hawkish than market participants.
- Consumer confidence troughed earlier in the year, and earnings have held up reasonably well.
- We looked for geopolitical hotspots to cool, but the opposite has happened, with Hamas invading Israel, a prolonged Russia-Ukraine war, and increased tensions with China.

While we made some good progress on many signposts in 2023, we'd like to see more improvement.

IN-DEPTH: OUR SIGNPOSTS SHOWED SOME PROGRESS TOWARDS FINDING BALANCE, BUT WE WANT TO SEE MORE.

Our signposts for finding balance in 2023 focused on China finally reopening after the pandemic, inflation drivers, Fed policy, market catalysts like confidence and earnings, and geopolitics. Going deeper:

- China reopened early in the year, but troubles remain:
  - Companies are diversifying supply chains and moving some production away from China while the U.S. and other countries are setting policy aimed at safeguarding industries like semiconductors.
  - China's economy saw price deflation, weakening consumer demand, and a faltering property sector, which led to its equity market being one of the worst performing this year.
- We've seen some improvement on inflation and its drivers:

    - Shelter costs: This Consumer Price Index component hit a monthly high of 0.8% in February, but the increases have averaged 0.4% over the last three months. We expect shelter inflation to fall further.
    - Labor market equilibrium: Back in September 2022, there were two jobs available for every person looking for work, but this ratio has fallen to 1.34, representing progress toward the balanced level of 1.0.
    - Wage growth: Peaking at 6.7% in July 2022, wage growth has fallen to 5.2%, still above the Fed's preferred 3%-3.5% range.
- While Fed policy and market forecasts for future Fed policy better aligned, they differ again:
    - On September 20, 2023, both the Fed Summary of Economic Projections (SEP) and fed funds futures forecasted a year-end fed funds rate of 5.6%.
    - But for the end of 2024, the Fed's most recent forecast is 5.1% while futures are signaling a 4.1% level, signaling that these forward-looking views are again misaligned.
- Some improvement in consumer confidence and positive earnings have supported a positive stock market:
    - The University of Michigan Consumer Sentiment Index hit a low of 59.0 in May, recovered to 71.5 in July, and then weakened again as inflation surprised to the upside and the S&P 500 corrected.
    - 2023 S&P 500 earnings are forecasted to be up 1.7%, better than the 0.9% forecast earlier in the year, even as 2024 earnings are expected to grow 11.7%.
    - The S&P 500 is up 20.3% year to date.
- We looked for geopolitical hotspots to cool, but the opposite has happened:
    - Hamas invaded Israel and Israel has responded, increasing tensions in the Middle East.
    - The Russia-Ukraine war continues with no end in sight, and Ukraine allies may be growing weary of providing support for the war.
    - We see increased tensions with China:
        - China has become increasingly focused on swaying foreign diplomacy this year, having attempted to outline a peace proposal for Ukraine and brokering a Saudi Arabia-Iran deal.
        - The U.S. announced export bans on AI chips and restrictions on investments, while China countered with restrictions on rare earth mineral exports.

CONCLUSION

We made good progress on many signposts in 2023, ultimately seeing the labor market and inflation cool meaningfully, stronger-than-expected economic growth, and a strong stock market return. We'd like to see more improvement with labor, inflation, and geopolitics. These issues will inform our outlook for 2024, which we plan to publish the first week of January.

Michael P. O'Keeffe, CFA
Chief Investment Officer
michael.okeeffe@stifel.com
www.stifelinsights.com

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