WESTEND
Advisors
A VICTORY CAPITAL® INVESTMENT FRANCHISE

Economic and Market Commentary

**December 13, 2023**

# 2023 Year-in-Review
# Narrow Rally and Mixed Signals

Risks abounded in 2023, yet some areas of the U.S. and global economy showed significant resilience. As a much-predicted recession failed to appear, inflation cooled, and the Fed eventually paused, U.S. equities posted a strong-but-narrowly-led rally, while elevated yields provided positive returns for fixed income year-to-date, despite interest rate volatility.

*As we near the end of 2023, we look back at some of the year's key economic and market developments, as well as how key portfolio allocation decisions evolved along the way (see call-out boxes).*

## 2023 YTD OVERVIEW (through December 13, 2023)

- Based on a range of indicators showing late-cycle conditions, we had anticipated slowing economic growth with an elevated risk of recession in 2023.
- U.S. real GDP slowed in Q1 and Q2, but jumped in Q3 as a sharp inventory build, government spending, and a residential construction rebound helped bring YTD growth near its 20-year average.
- Various developments that threatened economic contagion, including a spate of bank failures in the first half of the year, were contained with minimal impact to the economy or markets.
- The S&P 500 has returned over 24% YTD, but gains were concentrated in mid-phase sectors, with a few large tech-related names contributing the bulk of returns – many other categories of U.S. stocks, including early-phase cyclical sectors, late-phase defensive sectors, and value stocks materially underperformed.
- The Fed initially continued to hike the Fed Funds rate amid elevated inflation readings and continued economic growth, before pausing in Q3 and ultimately signaling likely cuts in 2024.
- Volatility in longer-term interest rates weighed on bond prices for much of the year, but a recent rate pullback muted that impact.
- International stocks have underperformed the U.S. YTD across most regions as Europe and emerging markets, most notably China, struggled with ongoing economic challenges.

**January 2023**
We shifted further toward defensive positioning across our ETF strategies, with a modest increase in late-phase U.S. sector exposure and, in traditional balanced portfolios, an increased overweight of fixed income.

## WHAT WE SAW COMING INTO 2023

In the U.S. at the start of 2023, a number of deteriorating macroeconomic trends warranted caution, in our view. Various leading indicators, including the Leading Economic Index and an inversion of the Treasury yield curve, were at levels that typically precede recession. While inflation had started to ease slightly, and we expected it would continue to do so, it remained near 40-year highs, which we saw as a headwind to economic growth and corporate profits growth.

U.S. consumer spending and incomes, as well as overall job growth, had remained strong throughout 2022, but we anticipated consumers would face more challenges in 2023. Spending had been fueled by a sharp reduction in the personal savings rate and a drawdown of excess savings that we viewed as unsustainable. By the start of 2023, the savings rate had fallen to lows not seen outside the Great Financial Crisis, and the cushion of excess savings consumers had accumulated was quickly depleting. Additionally, we were beginning to see payrolls decline in several leading areas of the job market, suggesting risk to overall job growth (a lagging indicator).

Crucially, the Federal Reserve was in the midst of its sharpest set of rate hikes in half a century. We also believed that the Fed's potential focus on wage inflation would push out a Fed pause/pivot beyond the consensus expectation of an early/mid-2023 timeframe. Meanwhile, banks were tightening lending standards, borrowing costs for consumers and corporations had risen dramatically, and broad measures of corporate profits were rolling over. Some areas of the economy, such as real estate, were already seeing headwinds from the Fed's actions, but we believed (and still believe) that the broader economic impact of that tightening had yet to be fully felt.

**Initial portfolio positioning:** Overall, we saw the U.S. economy as firmly late-cycle, with slowing growth (despite pockets of strength) and increasing risk of recession. From an earnings point of view, we believed consensus expectations for roughly 5% earnings growth for the S&P 500 in 2023 were too optimistic. Thus, we had positioned U.S. exposure defensively across our portfolios, with a key overweight of late-phase, defensive sectors that tend to have low economic sensitivity. We were largely avoiding early-phase sectors where we saw the greatest risk to earnings in a slowing growth environment.



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A key focus of our positioning was managing the economic risks we perceived, but we also saw ongoing strength in parts of the economy and sought to manage risk around the uncertainty in our outlook. That is part of why we also held a substantial allocation to mid-phase sectors like Information Technology and Communication Services. These sectors provide some economic sensitivity but tend to be less cyclical than early-phase sectors like Industrials and Energy, and they also have secular trends that we believe bolster their earnings growth.

In global portfolios, we were overweight our desired U.S. exposures and underweight Europe and emerging markets. We have maintained an overweight of developed Asia, as we saw particular opportunities in Japan's relatively easy monetary policy and its potential for revived nominal GDP growth to support earnings growth. In traditional balanced portfolios, we started 2023 with (and later extended) an overweight of fixed income and an underweight of equities.

## WHAT CAME INTO THE PICTURE OVER THE YEAR

**Glancing blows and dodged bullets:** We view a number of developments in 2023 as "dodged bullets" – issues that could have precipitated economic or market turmoil but that ultimately had only limited impact. A notable example was the failure of several regional U.S. banks in the first half of the year. Rising interest rates had reduced the value of various securities that banks hold as capital. For several banks with concentrated depositor bases, high withdrawals forced the sale and/or mark-to-market of those losses, leaving the banks functionally insolvent. Fortunately, various government backstops, including an implicit promise of essentially unlimited depositor protection, helped stem the risk of wider bank runs and further financial contagion.

**Early June 2023**
We increased our Treasury overweight in balanced strategy fixed income allocations.

Other economic threats also proved largely toothless. A post-COVID retail inventory glut may have contributed to a handful of bankruptcies, but most retailers seem to have worked through the issue; a wave of spending cuts and layoffs at major tech firms proved contained; and an ongoing drop in existing home sales, of similar scale to the real estate bust in 2008, seemed partly tied to fewer home listings that likely helped boost demand for new construction.

**Greater than expected economic supports:** While many of the negative trends and risks we identified at the start of 2023 persisted throughout the year, they were at least partly offset by a range of factors that supported ongoing economic growth. We expect some of these factors to prove temporary, but they have had the apparent effect of extending the economic cycle through this year.

One such boost to growth was from government spending, including support for infrastructure investment in various high-tech industries such as semiconductor manufacturing. Another boost was from personal income growth, supported by a robust return of participants to the labor force, as well as the decline in inflation, which lifted real incomes. Yet another was a large backlog of manufacturing orders that built up amid COVID-related supply chain constraints and which provided demand for new production as inventories normalized.

Other factors helped forestall the anticipated hit from higher interest rates, in our view. Many companies had previously pushed out debt maturities when interest rates were still relatively low, which prevented the need to roll over maturing short-term debt at higher interest rates in 2023. Fiscal support during the pandemic also helped limit business and household leverage; and credit conditions, though tightening, have remained relatively stable. Thus, much of the negative impact we anticipated from the Fed's hiking cycle seems to have been averted in 2023 or at least been pushed out to 2024.

## NAVIGATING 2023 MARKETS

Navigating markets amid the mix of economic risks and supports in 2023 presented challenges. Investors held record levels of cash on the sidelines, reportedly more than $5-$6 trillion. Whether investors were buying into the "death of the 60/40 portfolio" narrative that pervaded after weak returns for both equities and fixed income in 2022, or they simply felt comfortable earning current yields on cash given elevated uncertainty, holding cash meant missing out on potential double-digit returns YTD that might have been generated in a broad equity or traditional balanced portfolio. Beyond cash, however, the narrowness of market strength presented potential pitfalls. For example, fund flow data and anecdotal evidence suggest many equity investors had a "value" style tilt leading into 2023. Based on the Russell 1000 Value Index YTD, this approach may have produced returns closer to cash than to the broader S&P 500.

From a sector perspective, both early-phase cyclical sectors and late-phase defensive sectors have underperformed the S&P 500 YTD, with returns that averaged about 5% versus an average of nearly 49% for mid-phase sectors. Our avoidance of early-phase sectors and overweight of late-phase sectors in 2023 had some offsetting impacts, but significant exposure to the mid-phase sectors, along with regional selection in global portfolios, allowed us to capture the bulk of benchmark returns in our portfolios YTD. We seek to outperform our portfolios' benchmarks over the course of a full economic cycle. We believe the steps we took to manage risk this year have helped further that goal, given the ongoing macroeconomic risks we have seen and the degree to which an investor might have needed to concentrate in mid-phase exposure to outperform YTD.

**Mid-October 2023**
We modestly increased mid-phase U.S. sector exposure across our ETF strategies.

Looking forward, we still see a wide range of risks that justify caution, though we also see opportunities in the potential for a soft landing. The path we see as least likely in 2024 is a dramatic reacceleration of economic growth. Thus, for now, we continue to hold a mix of defensive exposures and exposures with moderate economic sensitivity across our portfolios. We look forward to outlining our 2024 outlook in greater detail at the beginning of January.

**WestEnd Advisors Investment Team | December 13, 2023**

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