Citi Global Wealth
Investments

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Potential Opportunities After a Strong 2023

- For the last two months of 2023, both stock and bond markets went in one direction, up. For the fourth quarter of 2023, global equities rose 11.0% and bonds +6.8%. This was driven by convincing data showing that the Fed would not need to crash the US economy to push inflation lower.
- The fact that equities and bonds rose together in the final quarter of 2023 shows how important the expectations for a change in Fed policy - from driving down inflation to potentially protecting an economic recovery - has been.
- In 2023, the stock market indices were driven higher by large gains for a handful of firms. Yet, the first few days in 2024 indicate that investors doubt that multi-trillion-dollar US tech franchises can continue to beat earnings expectations after a projected 44% earnings per share (EPS) gain in 2023.
- Investors can easily be misled by share price movements around holiday periods when market volumes and liquidity are low.
- For 2024, we believe a broadening recovery for the equity market is likely to co-exist with a pause and more volatility for last year's leaders.
- The expectation for near-immediate Fed easing is impatient and exaggerated. Yet the economic outlook is pointing to a healthier growth period ahead even if the Fed does not provide immediate rate cuts.

Potential Opportunities After a Strong 2023

For the last two months of 2023, both the stock and bond markets went in one direction, up. For the fourth quarter of 2023, global equities rose 11.0% and bonds +6.8%[1]. US asset performance was slightly stronger as US Treasury yields fell 70 basis points while credit spreads tightened.

The end-2023 rally was based on views that we clearly expressed in our Wealth Outlook 2024 publication:

- Inflation is headed towards the Fed's target of 2% by the end of 2024. Slower inflation will allow for a healthier growth period and more benign monetary policy over the coming two years.
- The likelihood of future rate hikes is now low and the probability that the Fed begins to focus on supporting a sustained recovery has risen sharply.
- The US economy has been more resilient than expected. In fact, a corporate earnings rebound is underway. It began from a low in Q1-2023 and now we see quarterly comparisons (year over year) with positive EPS growth.
- December's headlines for US employment were stronger than consensus forecasts. Nonetheless, employment growth is softening. Over the past year, US employment grew by 2.7 million. During 2022, the gain was 4.8 million. In 2021, 7.3 million. The path of slowing will not abate while monetary policy is restrictive.
- Tax-related activities accounted for part of a mid-December trading volume surge. A recent plunge in volume – while markets remain open – is related to holiday vacations.
- The so-called "Magnificent 7[2]" US tech megacaps were responsible for 53% of the S&P 500's total return in 2023 and 66% of the Nasdaq composite gain. However, in the final two months of 2023 we began to see a broadening of equity performance.
- Bonds rallied, with the 10-year US Treasury hitting a low of 3.79% on December 27, not far off from our forecast a full year from now. Cash yields are likely to fall meaningfully over the course of 2024 into 2025 and a normal (upward sloping) yield curve is on the way.

The fact that equities and bonds moved so strongly together is unlikely to continue. The economic outlook is pointing to a gradual slowdown for US labor markets, but healthier, sustainable growth ahead. The Fed is unlikely to provide the immediate "lower rate" satisfaction markets anticipate. We believe a "broadening" of equity market performance is likely to co-exist with last year's hottest sectors seeing some setbacks or meaningful pauses.

After some strong headlines for December's job gains, short-term fixed income markets reduced their expectation of Fed easing in March toward 50%. Markets subsequently jumped back to the conclusion that the Fed will soon ease after a weak private sector services survey. All such data is subject to significant noise in the winter months. While the Fed tends to act faster than its own economic forecasts imply, this is an aggressive assumption in our view. Initial action from the Fed in the May-June time window seems more likely.

There Is No "Bad January" Effect

Indices in 2023 were driven higher by large gains for a handful of firms. Yet, the first few days in 2024 indicate that investors doubt that multi-trillion-dollar US tech franchises can continue to beat earnings expectations after a projected 44% EPS gain[3] in 2023.

Short-term professional traders have vastly different goals and behaviors than committed long-term investors. An ideal trader's market is one where trading volumes are low, markets are inefficient, and short-term trends can be exaggerated. That's certainly been the case the first week of 2024. Following typical patterns, US equity trading volumes briefly doubled in mid-December 2023 and then halved in the period that followed.

With this dynamic, low-volume markets become more prone to price swings that are not indicative of underlying trends. Seasoned investors are careful to take market movements during these periods with a grain of salt.

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1 Source: Bloomberg as of January 4, 2023

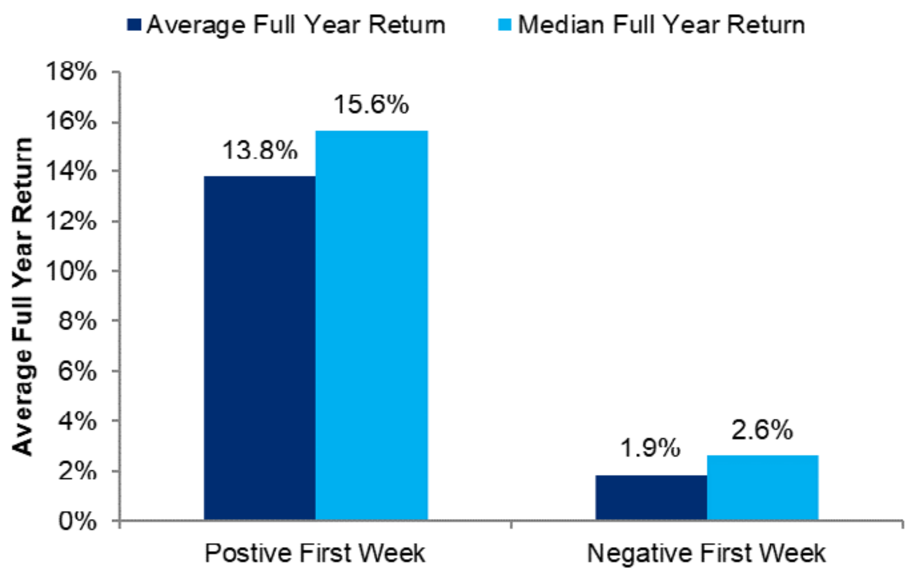
2 The Magnificent 7 stocks include Amazon.com (AMZN), Apple (AAPL), Google parent Alphabet (GOOGL), Meta Platforms (META), Microsoft (MSFT), Nvidia (NVDA) and Tesla (TSLA). The securities or company names included herein are for illustrative purposes only and do not constitute a recommendation of or solicitation to purchase or sell any security.

3 Source: Bloomberg as of January 4, 2023

Bad "Januarys" do not portend bear markets without the necessary bear market preconditions. Two recent examples are 2020 and 2021, when bad Januarys meant nothing for strong full year results. 2008 was a different situation. A housing/credit collapse – not a "weak January" – was the fundamental problem.

But, if you watch financial news, you will be hearing about the averages without context (see **FIGURE 1**). In our view, it is not a good idea to extrapolate much from an illiquid holiday market. Such data mining is simply picking information without describing the various circumstances that drove the results.

FIGURE 1: S&P 500 Full Year Returns with Positive First Week vs Negative First Week



Source: Bloomberg as of January 4, 2023. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. **Past performance is no guarantee of future results.** Real results may vary.

Important Portfolio Opportunities Remain Intact

Bonds

With the final quarter of 2023 driving it, global fixed income returns in 2023 were +7.0%[4]. Even now, intermediate US corporate yielding around 5% remain double the expected inflation rate over the next several years, offering solid value (see **FIGURE 2**). The early 2024 "give back" in fixed income is making available yields more attractive. Short covering and holiday illiquidity in late December had driven yields down towards our end-of-2024 target.

Equities

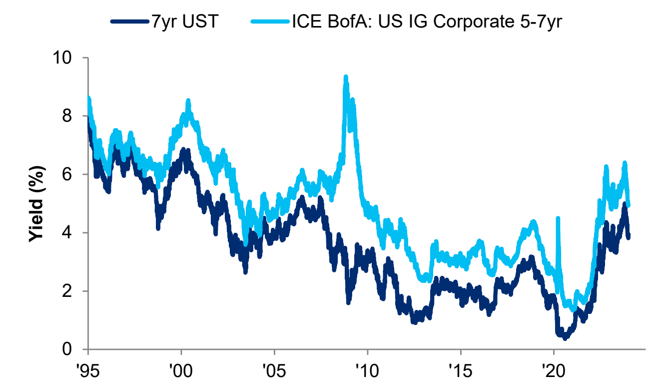
We can still potentially see a double-digit US equity return for the "average stock in 2024" even if the S&P 500 does not repeat its 26% 2023 return. As we pointed out in our last bulletin on December 17, 2023, the S&P 500 equal weight index has returned more than the traditional market cap-weighted S&P 500 in 50% of all years in the last three decades. The absolute value difference has been 6%. (Last year saw the largest underperformance of the equal weight index since 1998.)

It does not take an aggressive S&P 500 earnings target to drive double-digit returns for more firms' share prices in 2024. What it would take is a recovery in a wider swath of industry profits. Last year's profit decline for the majority of S&P 500 sectors suggest that a broader corporate earnings recovery is more, not less, likely.

Profitable small and mid-cap growth companies offer an unusually large valuation discount as a starting point (see **FIGURE 3**). As we discussed in our Wealth Outlook for 2024, we are tech optimists. A correction in large cap US tech is likely to be an opportunity. But there are more potential opportunities for growth and diversification than the "Magnificent 7" large tech franchises (see **Figure 4**).

[4] Source: Bloomberg as of January 3, 2023

FIGURE 2: Yields Lower but Not Low: US Intermediate Investment Grade Corporate and US Treasury Yield (%)



Source: Haver Analytics as of January 2, 2024.

FIGURE 3: The Valuation Gap Favoring Smaller Growth Firms. Price/Earnings: S&P 400, 500, 600 Growth Indexes

Source: Haver Analytics as of January 2, 2024. Large/Mid/Small Cap Growth proxies are S&P 500/400/600 Growth Indices.

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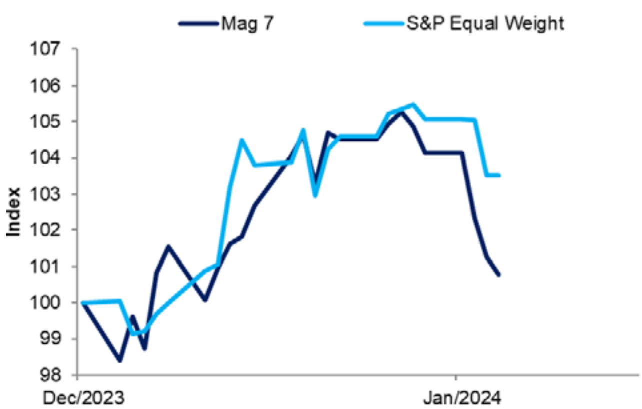
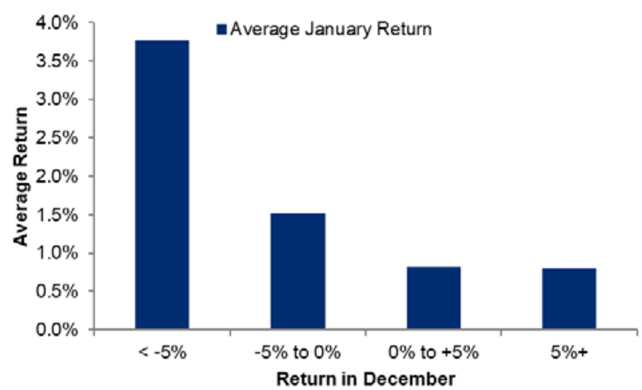
FIGURE 4: S&P 500 Equal Weight Index vs "Magnificent 7" Tech-Related Mega Caps



Source: Bloomberg as of January 3, 2024. Data range December 2023 to January 3, 2024.

FIGURE 5: January Returns for S&P 500 Sorted by Preceding December (Data since 1943)



Source: Haver Analytics as of January 4, 2024.

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Those Who Hesitate Are Lost

History does not lie. What you pay for assets will help determine their future return. A 22% total return for global equities in 2023 (26% for the S&P 500) will likely reduce 2024 total returns. And very strong December periods can make for more subdued Januarys (see **FIGURE 5**).

Remember this:

- In the last seven decades, the S&P 500 total return index has been positive in 74% of calendar years.
- 2020, 2021 and 2022 all saw a down month in January, with full year gains in 2 of the 3 years.
- Of the 26 years since 1954 that had a negative first week of the year, 50% (13) still showed positive full year returns. These have averaged +13.2%[5].

With this in mind, investors who dwell on short-term setbacks may miss the opportunity to allocate appropriately for their long-term goals. In our 2024 Wealth Outlook, we noted that there have only been three calendar years of decline in both US equity and bond returns during the past century, with 2022 being one of them. In the two cases where we can observe 24-month returns thereafter, the minimum cumulative gain was 24.2% for a 60/40 mix of the S&P 500 and 10-year US Treasury.

If we looked at all 12-month periods with both negative stock and bond returns, not just calendar years, the story is the same (see **FIGURE 6**). Following joint declines in US stock and bond returns over any 12-month period, returns were positive for a 60/40 mix in 41 of 41 cases two years later. The median cumulative gain was 28%.

FIGURE 6: Returns following periods of joint US stock/bond losses since 1928 (41 monthly cases)

	2-yr subsequent returns 60/40 cumulative
% of cases with subsequent returns positive	100%
Average Return	**33.1%**
Median Return	**28.0%**

Source: CGW Global Asset Allocation and Quantitative Research Team, Global Financial Data (GFD) as of December 31, 2023. S&P 500 Total Return is used for stocks and US 10-Year Govt. Bond Total Return (Provider: GFD) is used for the bonds. Note: 60/40 returns show the combination of the annual total return of the S&P 500 and the 10-Year Treasury with 60% allocated to the S&P 500, and 40% allocated to the 10-year. The historical allocation levels use indices and are provided for informational purposes only. The historical index allocation levels should not be taken as an indication of future performance, which may be better or worse than the levels set forth above. The index returns shown do not represent the results of actual trading of investor assets. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

Conclusion

The fact that equities and bonds rose together in the final quarter of 2023 shows how important the expectations for a change in Fed policy - from driving down inflation to potentially protecting an economic recovery - has been.

The expectation for near-immediate Fed easing is impatient and exaggerated. Yet the economic outlook is pointing to a healthier growth period ahead even if the Fed does not provide immediate rate cuts.

For 2024, we believe a broadening recovery for the equity market is likely to co-exist with a pause and more volatility for last year's top performers. Ignore talk of a January effect.

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High quality (very strong)	Aa	AA	AA
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Medium grade	Baa	BBB	BBB
Not Investment Grade			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
In default	C	D	D

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