Vestor Capital
INVESTMENT & WEALTH MANAGEMENT

Economic and Investment Outlook

January 2, 2024

Equity Market Update

Equity indexes posted strong returns in 2023. Leading the way were U.S. large technology stocks that posted extraordinary gains as evidenced by the NASDAQ Composite and S&P 500's returns of 44% and 26% respectively. U.S. small-cap stocks posted robust gains in the fourth quarter, as long-term interest rates declined, pushing stocks up 15% for the year. The MSCI EAFE large-cap developed international index posted a solid gain of 18% despite a lower weighting to technology stocks vs. the U.S. Emerging market stocks lagged, with returns of only 10%, due largely to weakness in Chinese equities, caused by investor concerns over increasing government control of business and slowing growth.

Despite restrictive monetary policy and high inflation throughout the world in 2023, stocks posted solid gains which caught most investment strategists by surprise. Businesses were generally able to pass on higher costs and maintain strong profitability. Markets really took off over the last two months of 2023 when it became clear that interest rate hikes are likely over. The other key catalyst for markets were prospects for generative artificial intelligence (AI) and the impact it will have on productivity. While it may take time for this to come to reality, investors are getting in front of this potentially game changing technology.

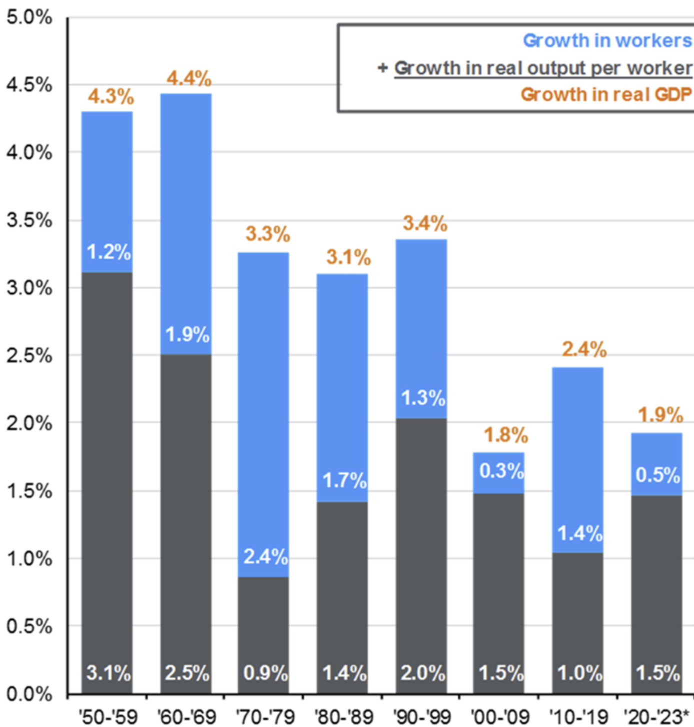
Total Return Performance for the Major U.S. and International Stock Market Indexes	
Equity Index	***YTD December 31, 2023***
United States	
Dow Jones Industrial Avg.: 30 Stock Composite	**16.18 %**
S&P 500 Composite: U.S. Large Cap	**26.26 %**
NASDAQ Composite: Technology Heavy	**44.70 %**
S&P 600 Small Cap: U.S. Small Cap	**15.94 %**
International	
MSCI EAFE Large Cap: Europe, Asia & Far East Large Cap	**18.95 %**
MSCI EAFE Small Cap: Europe, Asia & Far East Small Cap	**13.76 %**
MSCI EM Emerging Market: Emerging Market Countries	**10.12 %**

Source: Bloomberg, L.P.

Economy

The most widely viewed measure of economic growth is gross domestic product (GDP). The graph below highlights that real GDP (which excludes inflation) is comprised of growth in workers and real output per worker (productivity). The increase in our standard of living is due to real GDP growth over time. Notably, GDP growth has been relatively steady over the past 20 years at around 2%, which is lower than the 3-4% that the U.S. enjoyed between 1950 and 2000.

Growth in workers going forward will likely be a challenge due to lower birth rates, an aging population and our dysfunctional immigration system. Therefore, we will need productivity growth to increase our standard of living going forward. Faster drug discovery, improved agricultural yields, robotics, and targeted educational content are just a few areas where AI can improve outcomes. We are very excited about the potential of AI as the world has been looking for a game changing technology to drive productivity higher for many years and the potential for AI is significant.



Source: JPMorgan Guide to the Markets 12/31/2023

U.S. Market Outlook

We noted in our commentary last year at this time that if we exited 2023 on a high note with regards to corporate earnings, equities would "perform well in 2023", which proved to be prescient, although we certainly did not expect the magnitude of gains that were realized. It is interesting to note that there is an unusually wide range of opinions as to how markets will perform in 2024. While it is always a difficult task to make market forecasts, we acknowledge that the wide range of opinions today highlights greater than usual uncertainty. Given the strong performance in equities and fixed income in 2023, we have more tempered expectations for 2024. However, if employment remains strong and inflation continues to recede, we believe the set up is good for equites, fixed income as well as alternative investments for 2024.

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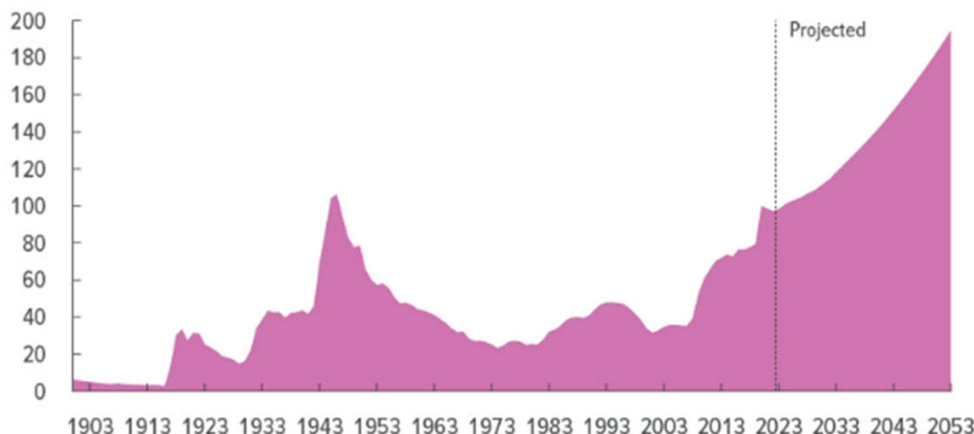
Rising U.S. Government Debt

The graph below highlights the fact that U.S. government debt as a percentage of Gross Domestic Product is projected to increase dramatically over the next 20 years, after already increasing rapidly over the most recent 20-Year period from 2003-2023. Interest, health care and Social Security costs are the primary drivers of the increase. Of course, the most important question is what does this really mean for U.S. citizens and investors going forward? While many pundits are projecting doomsday scenarios, it is important to remember that rising debt levels from 2003-2023 did not negatively impact equity markets, as the S&P 500 has grown at a compound rate of just under 10% over this period. Also, interest rates until recently have remained relatively low.

We share the general concern that these rising debt levels are not ideal but are not convinced that they will be a headwind to economic growth and the general well-being of U.S. citizens. As Yogi Berra once said, "It's hard to make predictions, especially about the future." There are so many variables to consider that we believe it wise to just admit that we don't really know what will be the impact of rising debt. We will remain vigilant in monitoring this situation and look for risks as well as opportunities related to this growing debt load.



Debt is projected to rise in relation to GDP, mainly because of increasing interest costs and the growth of spending on major health care programs and Social Security.

Source: Congressional Budget Office (CBO) February 2023

Inflation, Interest Rates & Fixed Income

The graph on the next page highlights how inflation is now receding from elevated levels. The Federal Open Market Committee (FOMC) has paused interest rate hikes due to the improving inflation picture. Recall that the current federal funds rate of 5.25% - 5.50% is well above the FOMC's neutral rate of 2.5%. If inflation continues to fall and/or the economy softens, it is likely that the FOMC will cut interest rates in 2024. Bond prices move inversely with interest rates, which would be a tailwind for bond investors. While money market and short-term Treasuries performed well in 2023, they would be less attractive in a falling rate environment as money would have to be reinvested at lower rates. It is for this reason that we continue to believe that it is a good time to lock in the higher yields by adding exposure to longer dated bonds.

If inflation remains stubbornly high, then interest rate cuts may not come to fruition. However, we do not believe it is likely that the FOMC will restart the rate hike campaign unless there is a significant reacceleration in inflation, which appears unlikely, especially if the U.S. economy weakens.

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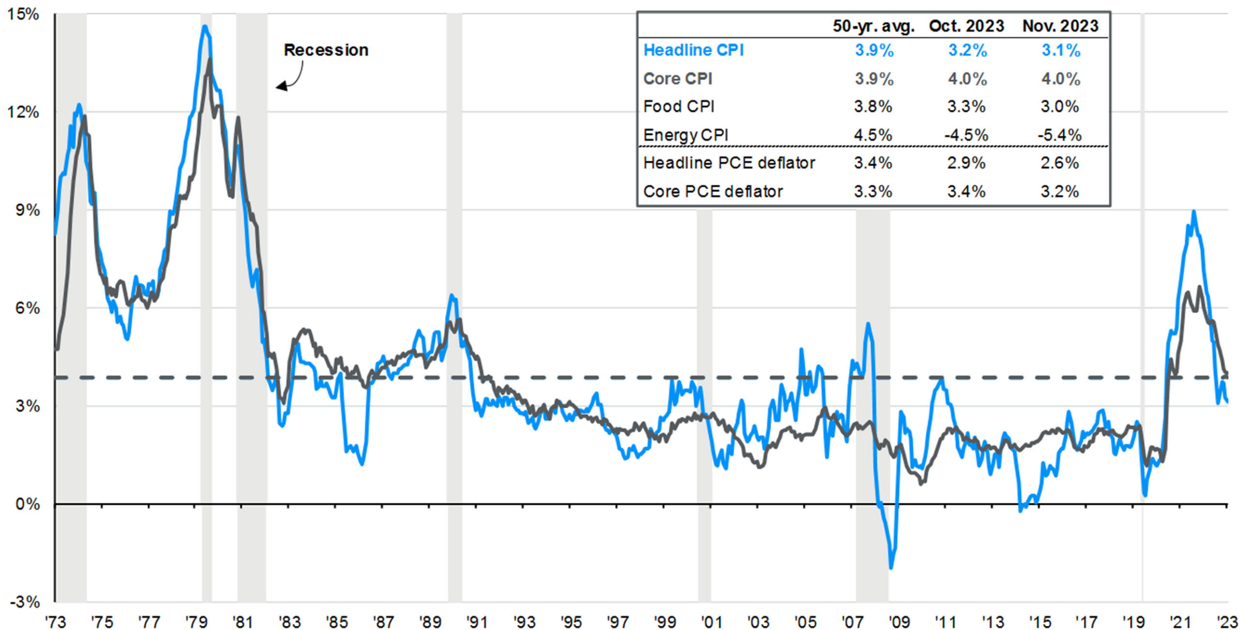

	50-yr. avg.	Oct. 2023	Nov. 2023
Headline CPI	3.9%	3.2%	3.1%
Core CPI	3.9%	4.0%	4.0%
Food CPI	3.8%	3.3%	3.0%
Energy CPI	4.5%	-4.5%	-5.4%
Headline PCE deflator	3.4%	2.9%	2.6%
Core PCE deflator	3.3%	3.4%	3.2%

Source: JPMorgan Guide to the Markets 12/31/2023

Summary

After a difficult year in 2022 for both equites and fixed income, 2023 was a banner year as inflation receded, economic growth continued, and it appears interest rate hikes are behind us. We are hopeful that we are entering a more normal investing environment in 2024, after heightened volatility between asset classes over the past few years.

While not our base case, there is certainly risk that world economies weaken somewhat in 2024. Economic growth in Europe and China is already slowing, and the U.S. consumer appears tired. If the U.S. and/or world economies weaken in 2024, this will likely cause monetary authorities to begin cutting interest rates, which would be a tailwind for high quality bonds which would appreciate. Equity performance is less certain as investors typically buy into economic weakness as they look to a brighter future.

When it comes to investing there are always plenty of events that can cause markets to fall in the short-term. This has been clearly evident since 2000, as we have weathered a technology bubble, financial crisis and Covid outbreak. However, it is during this period that some of the best investment returns have been realized, highlighting the wisdom of looking through market turbulence. Best wishes for a healthy and happy 2024!

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