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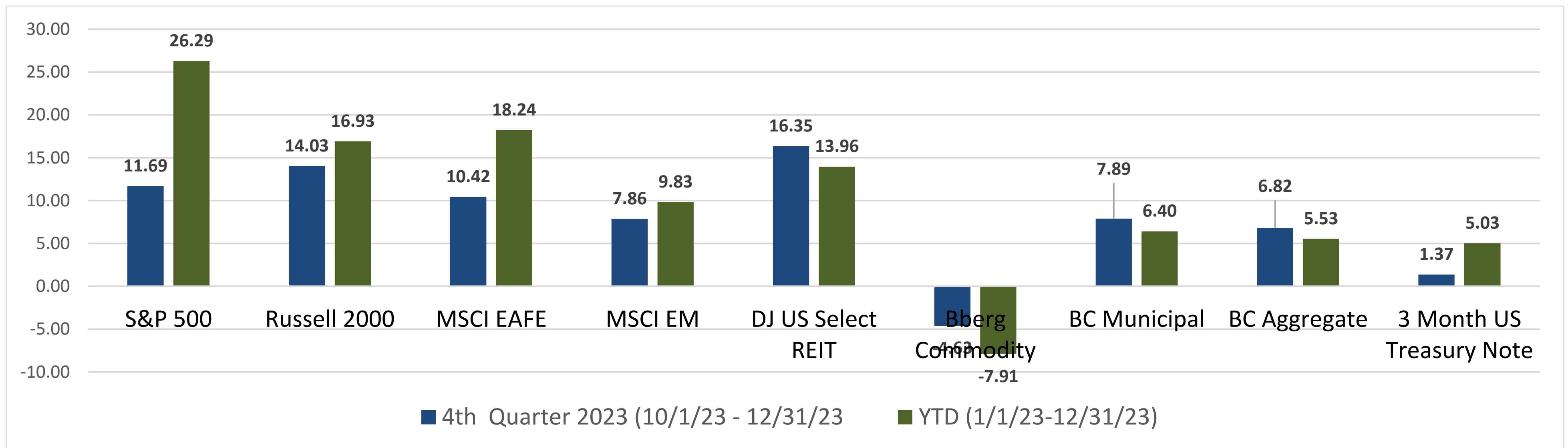
Patience & Resilience: How We Got Through a Year Driven by AI & Interest Rates

Schneider Downs Wealth Management Advisors, LP

Q4 2023 Market Commentary



I have a tradition every year dating back to my first year getting into the investment world; I go into the office and work the last day of the year. Save for the COVID year in 2020, it has become a ritual for me to close out the year by heading into the office. Traffic is benign, Downtown is mostly quiet; it is a good time to reflect on the year that was. The last two years I have roped my two daughters, Caroline (8) and Claire (4), into my year-end tradition. While they were running around the office, coloring, watching Bluey on the iPad, and eating chocolate (that I promised my wife I wasn't going to give them), I took inventory of the year and all that happened. Amid the laughter, smiles, and a special lunch downtown, the gravity of what occurred in 2023 began to settle into the frame. The sharp rally in risk markets over the last 45 days of the year had temporarily obfuscated the fact that we had three major bank failures in late February/early March. Silicon Valley Bank (SVB), the highest profile bank failure, was relegated to a footnote in the year after being front and center almost nine months earlier. For the first time in several decades, we had wars going on in the Middle East and in Eastern Europe, yet international stock markets, both developed and emerging, delivered double digit returns. On top of all of that, we had the highest levels of interest rates in almost 20 years domestically. The level of interest rates created elevated volatility across all risk asset classes (minus the Magnificent 7 technology stocks – we will get to them in short order) for most of the year, causing heartburn and consternation along the way. As the clock struck 4:00 pm and the stock market was officially closed for the year, I couldn't help but draw the parallel between the year in markets in 2023 and the final day in the office in 2023 with Caroline and Claire. A whole lot happened in what seemed to be such a short period of time… but as I packed up my office to head home, my girls had smiles from ear to ear and I couldn't help but feel it was the perfect way to end an unexpectedly good and wholly unpredictable year in the markets.

The two driving forces in capital markets in 2023 were artificial intelligence and interest rates. Through the first three quarters of the year, the market could best be described as a case of the "haves" (e.g. the Magnficent 7 megacap technology stocks[1]) and the "have nots" (e.g. Small and Mid Cap stocks, financials, utilities, and publicly listed real estate). The Magnificent 7 and their ardent supporters could, and did, stake claim to the mantle of being the most direct beneficiaries of the "Artificial Intelligence boom." This AI boom, so they said, would lead to an eventual gold rush of

[1] The Magnificent 7 stocks are comprised of Apple, Amazon, Microsoft, Nvidia, Tesla, Alpahabet (Google), and Meta (Facebook).

revenue and profits that would rebound to the precious few companies that could stake their claim. The prices of the Magnificent 7 stocks[2] reacted like they were strapped to one of Space X's rockets, shooting up into the atmosphere while almost all other assets classes were stuck on the launching pad.

If the "haves" had a rocket strapped onto their backs, the "have nots" had a several-ton weight on their collective backs. The weight on the back of the "have nots" was the market's view that their exposure to a more sustained level of higher interest rates would negatively impact current and future results. Rocket pack vs. one-ton weight, or haves vs. have nots; this narrative played out for the first 10 months and 15 days of the year. The fulcrum for capital markets in 2023 was the U.S. Federal Reserve's decision to pause interest rate hikes in November,[4] and indicated to markets four weeks later in a December meeting that three interest rate cuts were possible in 2024.[5] The have nots, no longer shackled with the albatross of the negative implications of sustained higher interest rates for longer, rallied like they had the rocket pack strapped to their back (see corresponding table). While capital markets were driven by AI and interest rates, client portfolios in 2023 were driven by patience and resilience; resilience to hold up in the face of the last phase of U.S. Federal Reserve interest rate hikes and patience to continue to hold a diversified portfolio in the face of, at times, a narrow seven-stock market.

Market Index[3]	11/14/23 – 12/31/23 Return	4th Quarter 2023 Return	2023 Return
S&P 500 (large cap)	+8.39%	+11.69%	+26.29%
S&P 400 (mid cap)	+14.51%	+11.67%	+16.44%
S&P 600 (small cap)	+18.78%	+14.03%	+16.93%

Equity markets were incredibly strong across market capitalization and geography in the fourth quarter. As the top chart indicates, for the full year 2023, equity markets had double-digit gains across U.S. and international markets. These double-digit gains were due almost exclusively to the movement in the fourth quarter and to be more precise, the movement in the last 45 days of the year. The Russell 2000 (small cap) closed on September 30th +2.5% for the year; it would close out the year +16.9%. The MSCI EAFE (international developed) closed on September 30th +7.1% for the year; it would close out the year +18.2%. The rally was piercing and ferocious, and a most welcome and positive sign for markets and diversified portfolios. Before the pivot in capital markets in Mid-November, most equity asset classes were trading at a significant, and we would argue attractive, discount to U.S. large cap markets.

After the strong rally to end the year, those valuation gaps closed to a degree, but the S&P 500 still trades at around 19x forward earnings, meaningfully above U.S. small and mid cap, which trade around 14x.[6] This discount is almost entirely attributable to the aforementioned Magnificent 7. The sheer power of these megacap technology stocks to power through any and all questions in 2023 (and for that matter, over the past 5-7 years, save for 2022 where for a brief moment they proved fallable) has been equal parts intoxicating and vexing. The enrormity of these companies cannot be overstated; the Magnificent 7's total market capitalization is almost $12 trillion… when you write it out, it's the number twelve followed by 12 ZEROES ($12,000,000,000,000)![7] Another way to put the size of the Magnificent 7 into context is that the market capitalization of these stocks is

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[2] And certain others that could lay a claim to being a direct beneficiary of the AI boom
[3] Returns generated from Morningstar and our total return numbers (e.g. dividends rein)
[4] https://www.cnbc.com/2023/11/21/fed-minutes-november-2023.html
[5] https://www.barrons.com/livecoverage/fed-december-meeting-speech-rate-decision-today
[6] https://yardeni.com/charts/stock-market-p-e-ratios/. Numbers as of January 5, 2024. S&P 500 19.2x, S&P 400 MidCap 14.2x, and S&P 600 SmallCap 13.9x)
[7] You almost have to write it out to get the full effect. I sometimes think if we were to make our lawmakers write out how much money they want to spend of our tax dollars each and every year, it might make them tighten up our country's budget a bit. But I digress.

greater than the market capitalization of the equity markets in the United Kingdom, Canada, and Japaan combined[8]. Their growth and underlying performance has been intoxicating to be sure, but almost equally vexing. From a valuation standpoint, they appear expensive with growth assumptions that look to be difficult to continue to meet. In addition, there remain regulatory concerns by multiple bodies (U.S., Europe, China, among others) that do not appear to be priced into the valuations. For these reasons, we continue to believe that maintaining exposure to U.S. large cap is necessary and prudent, but the next incremental capital going into risk assets in client portfolios is best served going into more reasonably priced asset classes like U.S. small and medium companies and international stocks.

Stocks rallied hard in the last 45 days and that should rightfully be a big part of the narrative coming out of 2023. However, we would be remiss if we gave short shrift to the performance of bonds in 2023. Bonds faced similar challenges as the "have nots" referenced in the opening paragraph. Bonds had significant exposure to interest rates, and even after the difficult year in 2022 and subsequent reset in bond yields moving higher, they remained challenged through the first three quarters of the year. However, as the market saw the U.S. Federal Reserve pause and hint at a pivot (e.g. interest rate cuts in 2024) late in the year, bonds reacted almost as if they were stocks. The benchmark U.S. 10-year treasury yield hit an intraday high of 5% in mid-October; less than 45 days later, it would touch an intraday low of 3.78% in December. In some cases, municipal bonds rallied almost 8% in the quarter with U.S. treasuries and agencies not far behind, rallying almost 7%. For the few that were able to take their eye off the ferocious equity rally, they would have seen an equally impressive rally occurring in the fixed income market.

As we enter 2024, there remain many significant questions that will likely be resolved over the course of the year. Soft economic landing vs. hard economic landing, interest rate cuts vs. interest rate hikes, Republicans vs. Democrats in an important election year, Ukraine vs. Russia, Israel vs. Hamas, just to name a few. The known issues in 2024 are enough to be worried about without the unpredictable events that seemingly happen every year to contend with. With all these variables to navigate, it is more important than ever to have a steady hand at the wheel and an open dialogue between advisor and client. Alongside you as our trusted partners, we have built relationships rooted in trust and portfolios that are globally diversified to meet this challenging moment. While we cannot predict the future, we do know that whatever the market has in store for 2024, we will get through it together. Thank you again for your trust in the SDWMA team. We look forward to seeing you soon (preferably in person!). Have a wonderful start to 2024!

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[8] https://apolloacademy.com/how-overvalued-are-the-magnificent-seven/