2023 Year in review

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" What will happen in 2023 and forward? Forecasters are quite bearish, and sentiment is at or near record levels of pessimism. In October, Bloomberg's Economics model put the odds of a 2023 recession at 100%. One hundred percent, or the same as the chance that the sun will rise tomorrow morning. The strategists' targets for the market at year-end 2023 are on average the most bearish since 1999. A survey of individual investors shows bearish sentiment at an unusually high level."

– from our January 2023 letter

As it turned out, we ended 2023 on a high note. Nearly all major US indices registered strong gains and the technology sector led the returns. The Dow Jones Industrial Average increased 13.7%, S&P 500 increased 24.2%, the technology-heavy NASDAQ increased 43.4%, while the US Bond market (as measured by the S&P US Aggregate Bond Index) increased 5.8%.[1]

It is important to note that the gains were a reversal of the challenging markets in 2022. In 2022, all of these indices were down: Dow Jones Industrial -8.8%, S&P 500 -19.4%, NASDAQ -33.1% and the S&P US Aggregate Bond Index -12%.[2] Thus, the levels of these major equity indices are relatively flat when looking back to the end of 2021. On a total return basis, the S&P 500's 2023 strong performance ranks 24th going back to 1928, while on the contrary, 2022's total return was the 7th worst year since 1928.[3] Additionally, since the February 2020 peak (pre-Covid), the S&P 500 is up 50%, and since the March 2020 bottom the S&P 500 is up 126.5%.[4]

Why are we giving you this historic market context? We think it is imperative to understand that despite this market volatility, staying in the market is key. Markets go up and markets go down, and the market prognosticators often get it wrong. The predicted recession for 2023 didn't materialize. We don't believe that the economy can be consistently forecast, nor do we believe in timing the market. Generally speaking, you should expect a market drawdown of ~14% in every year (this has occurred every year on average since 1980), and markets were positive in 33 of 44 years since 1980.[5] We believe that the best probability for success and for achieving your goals is to stay invested. We buy equity stakes in businesses we believe to have strong competitive advantages, good management, and trade at a decent price that we aim to hold over the long-term.

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If you follow the financial media, you know that some of the most popular topics were the Fed and Artificial Intelligence. The bears got all worked up by the failure of a couple of small banks in March. Much was made of the fact that the stock market's performance was strongly influenced by the performance of just a few large technology-related companies (while mostly ignoring the sharply negative moves of those same stocks in the prior year). If you were paid to be a thinker of big thoughts, you probably obsessed over each monthly employment report and inflation statistic. After all that, we ended 2023 at the same place that we ended 2021. Rip Van Winkle would feel right at home.

Nonetheless, we must take notice of the fact that the stock market is near an all-time high with a correspondingly lofty valuation (as measured by price/earnings multiple). The 2023 equity market certainly experienced what's called "narrow leadership" (the top 10 stocks, representing about 1/3 of the total value of the market, made up about 86% of the return).[6] An unusually high percentage (72%) of stocks rose less than the S&P index itself—this is the second highest percentage of S&P 500 stocks underperforming the index since 1980.[7] Maybe that means that those top 10 are overvalued. Or maybe it means that the rest of the market is cheap. We don't know the answer, but we remain focused on quality individual holdings and look at valuation on a stock by stock basis.

A couple of other thoughts:

1. The Fed gets way too much attention from investors. I'm pretty sure that Chair Jerome Powell would agree. He was severely criticized—mocked, even-- when he said in mid 2021 that he expected the increase in inflation to be "transitory." However, as we look at the path of the Consumer Price Index, we see that it rose from 2.6% in March 2021 to 9.1% in June 2022 and at the most recent report is back to 3.1`%. Relative to the 50-year average, headline CPI is now below the historic average.[8] The financial media endlessly obsesses over the Fed's next move and debates a Fed "pivot." Our somewhat contrarian opinion is that the Fed is more of a follower than a leader. It responds to what it sees as changes in the economy and inflation (and the Fed doesn't care much at all about the stock market except at extremes).
2. The recession debate is a sideshow. Widespread predictions of a recession in 2023 were most likely because the forecasters were extrapolating history (which can be a deadly error in investing). The "inverted yield curve" (where rates on short-term bonds are higher than rates on longer-term bonds) was supposedly an infallible predictor which now seems to have been proven fallible. It's true that the pace of the Fed's rate increase had always resulted in a recession in prior cycles, but we're finding out that this cycle is different. The difference is that the current economic cycle has been dramatically affected in myriad ways by a once-in-a-century global pandemic, and apparently no one had that properly factored in. Eventually we'll have another recession, but they've been notoriously difficult to forecast.

As usual, our turnover (buying and selling) was low. Our goal is to buy the right stocks and hold them for a long time. However, we did make one significant addition to most portfolios by buying US Treasury notes with a 2 year maturity. Interest rates were last at current levels in 2007, and we've avoided bonds since then due to what we viewed as unattractive risk/return tradeoff. But in mid-year these government notes were available at around the 5% level for the first time in over 16 years. While we continue to prefer quality stocks in our long-term portfolios, we're willing to add more bonds or other bond-like securities as opportunities arise.

We're not specifically limited to investments in the United States, but recently our exposure has been overwhelmingly domestic. Technology is by far the leading source of economic growth, and the US is a clear global leader. The dollar remains the currency of choice for most of the world. Congress passed bills allocating nearly $5 trillion in domestic spending, much of which will go to infrastructure projects and will be a source of growth for many years.

Thank you for your confidence and the trust you place in our team. We take our job as stewards of your capital very seriously. While we invest for the long-term, we invest to meet your goals. As a reminder, if anything has changed, please let us know we will make any necessary changes or adjustments.

Happy New Year.

Kristan, John and Grant

[1] Bloomberg Market Data December 31, 2022 – December 31, 2023.

[2] Bloomberg Market Data December 31, 2021 – December 31, 2022.

[3] Data from Professor Aswath Damodaran at NYU Stern https://pages.stern.nyu.edu/~adamodar/.

[4] JPMorgan Guide to the Markets as of December 31, 2023.

[5] JPMorgan Guide to the Markets as of December 31, 2023.

[6] JPMorgan Guide to the Markets as of December 31, 2023.

[7] JPMorgan, Eye on the Market, by Michael Cembalest, January 01, 2024.

[8] JPMorgan Guide to the markets as of December 31, 2023.

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