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Equity Market Commentary

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Some thoughts as we commence 2024.

1. I am reminded of an old Wall Street axiom:

Just because the calendar changes, doesn't mean the trends do.

The powerful rally that kicked off in late October 2023 (right on cue in our opinion) continues into 2024.

2. For the five reasons we reviewed in our 2024 Market Outlook,[1] AEA expects another good year for equities in 2024.

However, we can't help but think the market is due for a breather here:

- The S&P 500 has rallied 13 of the last 14 weeks.
- It's up 20% off the October 27th, 2023 low.
- Breadth has started to narrow lately, a classic sign of short-term fatigue.

Could the S&P 500 at 5,000 be the rest stop?

3. As I think about the year ahead, I am reminded of another old Wall Street axiom:

    Reversion to the mean is the iron rule of the financial markets.

    What could be some "reversions to the mean" in 2024?

    Here are some potential scenarios that come to mind:

[1] 2024 Equity Market Outlook webcast, January 17th, 2024.

The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.**

a. In 2021, the uber growth names were the craze. Consequently, money poured into high growth strategies, and naturally, they got crushed in 2022… only to post a comeback in 2023.

In that same vein, the bears were the darlings in 2022, all over the media. So naturally, they got crushed in 2023. Absolutely stampeded whenever they mounted any opposition to last year's bull market.

Now could the bears mount a more successful campaign in 2024? I think they could, just as the uber growth stocks did when they came off the mat last year. They remain ripe for reversion to the mean.

I still believe 2024 will be a good year for equities. Yet I am respectful of the power of reversion to the mean, and the bears had about as bad a year in 2023 as uber growth managers had in 2022. The bears should have better days in 2024.

b. Speaking of the bears, had you ignored them in 2023 and just stayed invested….it was an easy year.

- The S&P 500 went up 8 out of the 12 months.
- It never went into the red for the year after the first day of trading.
- The VIX (volatility index) remained largely dormant all year, never bouncing much.

Reversion to the mean suggests significantly more volatility in 2024 with more days of the bull thesis being challenged. Additionally, it means more days for weak-handed investors to be scared out of equities.

While the economic backdrop is completely different, I suspect 2023/2024 will be like 2009/2010.

- Off the low in early-2009, the SPX rallied the remainder of the year with not even a single 10% correction.
- However, as it was the first year off the low, investors sold equities, expecting a continuation of the 2008 bear market.[2]
- Fund flows finally turned positive in 2010… just in time for a much more volatile year.
- While the S&P ended 2010 up 12.8%, the returns included a -16% gut wrenching decline late spring/early-summer.[3]

Seems like 2023 was like 2009, and 2024 could be like 2010.

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[2] Investment Company Institute.
[3] Bloomberg.

c. Active management had a miserable year on a relative basis in 2023. Just 38% of U.S. large-cap managers outperformed in 2023.[4]

To be clear, I am the first to admit I am a bit biased on this subject.

However, I would also argue that reversion to the mean is already happening in 2024:

- 73% of large-cap U.S. active funds outperformed in January 2024.

- January was the best month since 2007 for active management and the best start to the year since 1991.[5]

So why the reversion?

In 2023, 62% of the S&P 500 return came from the magnificent 7. Their average return was +111% and each one of them crushed the S&P 500 return.[6]

Certain jurisdictions have restrictions on active management's ability to hold these stocks both in terms of size and concentration.

Yet in classic reversion to the mean fashion, it has not been so good across the board for the magnificent 7 in 2024. Some good/some horrible. Hence, choosing the right ones and not owning all of them has mattered.

4. Of course, we are paid to have opinions about the future.

But some opinions I am more passionate about than others.

Something I have stressed recently:

The fallacy of valuation analysis.

How many times did you read in 2023 that there was no upside in stocks because the equity risk premium or the P/E was stretched?

Or that Europe was more attractive because it's "cheaper than the US"?

These types of announcements are all predicated on *somebody's ability to accurately predict earnings*.

Investors, in my opinion, take this accuracy as gospel, yet didn't we learn last year how wrong that could be?

[4] Barron's, January 6th, 2024.
[5] Bank of America, February 5th, 2024.
[6] Bloomberg.

That brings me to 2024:

As of February 6th, 80% of the S&P 500 members that have reported ***beat*** their Q4 estimate. For MSCI Europe that number is 26%. A woeful difference.[7]

That is not to say there are not good opportunities for individual stocks in Europe.

It is simply that estimates for the S&P 500 are likely going ***up*** and estimates for Europe are likely heading ***lower***.

Thereby making the S&P 500 cheaper than it looked and Europe more expensive.

5. I will close with one final Wall Street axiom:

   Investors stop worrying when politicians start worrying.

   Seems to me the Chinese authorities are starting to worry, and are taking some measures.

   I have been too bullish on the recovery in China.

   Although, to be fair, our largest Chinese stock in our global strategies posted a very solid year in 2023 and continues upward this year as well.

   Overall, however, the Chinese market has stunk longer than I expected.

   Given the added risk that government intervention could derail any of these stocks at any moment, I would ***not*** advocate a large allocation.

But I can't help but remember that old axiom.

Andrew

[7] Morgan Stanley Research, February 3rd, 2024.

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