Ultimately, 2023 Was a Year of Recovery. What's in Store for '24?

After a historically challenging year for the financial markets in 2022, 2023 was a year of recovery. The recovery occurred even though 2022's biggest challenge – rising interest rates – continued. Will the markets' forward momentum keep going in 2024?

Before we tackle that question, let's review. At the end of 2022, the stock market, as measured by the S&P 500, was down by 19.44%.* All three major market indexes were in the red after a year in which the Federal Reserve rapidly raised short-term interest rates to fight high inflation. From March to December of 2022, the Fed took its benchmark short-term rate from near zero to 4.37%. That historically aggressive pace pushed long-term interest rates from 1.74% to 3.83%. Since rising interest rates generally decrease the value of all assets, the bond market also struggled greatly. As I've noted before, 2022 was probably the most challenging year I've ever seen for bond investors thanks to that constant interest rate headwind created by the Fed.

Coming into 2023, however, I was optimistic that the worst was over. Inflation had been falling steadily for six months, and although the Fed was still talking tough, there were signs that they would probably greatly slow their rate-hiking pace in 2023. That likelihood increased in March when two regional banks failed, raising fears that another systemic banking crisis might be in the works. As I noted at the time, the Fed's aggressive rate hiking pace was directly responsible for those bank failures, and for putting many other regional banks at risk. The Fed's efforts had created a fully inverted yield curve, which occurs when short-term interest rates are higher than long-term rates. In addition to being a classic warning sign of a recession, an inverted yield curve creates many challenges for banks and other lending institutions, especially smaller ones.

The Tide Turns

Although several geopolitical issues also emerged in 2023 that could potentially have disrupted the markets (such as the war in Israel and another congressional showdown over the debt ceiling), investors remained laser-focused on the Fed. The markets saw bouts of volatility and struggled mid-year as the Fed continued raising rates in quarter percent increments – but compared to 2022 it was nothing. In the end, the Fed only raised short-term rates by another percentage point in 2023, compared to over 4% the year before. The Fed funds rate was 4.37% coming into 2023 and now stands at 5.37%. As for long-term rates, although the interest rate on the 10-year government temporarily hit 5% last year, it ultimately ended the year only a fraction of a percent higher than it started the year, jumping from 3.73% to 3.87%.**

Meanwhile, inflation continued to decline last year, GDP and unemployment numbers were consistently strong for most of the year, and the emergence of new artificial intelligence technology sent that sector of the stock market soaring. The so-called Big Seven tech companies (Google, Apple, Tesla, Meta, Amazon, Nvidia, and Microsoft) helped Wall Street finish 2023 up by roughly 26%, a recovery that happily wiped out all of 2022's losses.

Of course, as income investors, most of you don't have much invested in the stock market and even those of you who do are using our stock dividend strategies, which can't really include tech stocks because they generally don't pay dividends. The good news, however, is that the bond market also ultimately enjoyed a strong recovery in 2023 despite the continuation of rising interest rates. And for those of you in our portfolios of bond and bond-like instruments, your recovery was probably significantly better than the market average.

Your Portfolios

As you may recall, 2022 ended with your accounts down by about 13% on average, depending on your individual holdings. On your latest statement, you should see your accounts up by about 15% on average for 2023, again depending on your specific holdings. Although that may seem like a net gain of 2%, keep in mind that for every dollar you have in the market, a 13% loss means you only have 87 cents of each dollar left. The good news is that a 15% gain means you've gotten each dollar back and made a full recovery. The even better news is that because you're invested with us, your recovery was probably much better than that of many bond investors based on the Bloomberg Aggregate Bond Index, which finished the year up by just 5%.*** As I pointed out last month, our ability to outperform the markets to this extent is due primarily to the work of our excellent portfolio managers at Sound Income Strategies.

Of course, the best news, as I always stress, is that when you're investing for income, any gains or losses in your asset values are largely irrelevant because your interest and dividend return are unaffected. Still, psychologically, asset growth always feels better than shrinkage, so the recovery of 2023 is certainly worth celebrating!

Looking ahead, the Fed will continue to be a driving force for the markets this year. Although their rate hiking efforts are probably now finished, they have signaled they'd like to start lowering rates again this year. There is also still a slight chance the economy could tip into a recession. While that would likely put downward pressure on the stock market, falling interest rates would probably give bond investors a welcome tailwind. Of course, there are also still many geopolitical factors that could impact the markets this year, so it's important to stay informed.

On a final note, the ongoing error in some of your statements since our switchover to Charles Schwab last fall has not yet been corrected. You will continue to see preferred stock miscategorized in a way that appears to indicate an income loss. Again, this is inaccurate, and unfortunately, we are told the issue can't be quickly fixed. Until it is, any time you want to see accurate information about that particular investment, call our office and we will provide it.

**S&PGlobal.com*
***YCharts.com*
****"Strong 4th Quarter Return in Stocks and Bonds," Dec. 29, 2023, advisors.vanguard.com*

January 2024 Recipe: Skillet Mac & Cheese

Ingredients:

2 cups uncooked pasta (about 8 ounces), such as elbow macaroni, cavatappi, or shells
2 tablespoons butter
2 tablespoons all-purpose flour
1-1/2 cups half-and-half cream
3/4-pound process cheese (Velveeta), cubed
Optional toppings: fresh arugula, halved cherry tomatoes, and coarsely ground pepper

Directions:

1) Cook pasta according to package directions, then drain.

2) Meanwhile, in a large cast-iron or other heavy skillet, melt butter over medium heat. Stir in flour until smooth; gradually whisk in cream. Bring to a boil, stirring constantly. Cook and stir until thickened, about 2 minutes. Reduce heat; stir in cheese until melted.

3) Add macaroni; cook and stir until heated through. Top as desired.

The Skillet Mac & Cheese recipe is shown here:
https://www.tasteofhome.com/recipes/skillet-mac-cheese/