2023 Fourth Quarter Review

Sentiment markedly changed to end the year as **stocks and bonds benefited from improving inflation data and encouraging comments** from the US Federal Reserve (the Fed) on the direction of monetary policy going forward. Also promising is that economic data has so far suggested the United States is likely to achieve a soft landing, meaning that the labour market will not be severely impacted by the ongoing inflation battle. US stocks as measured by the S&P 500 Index gained 9% (CAD) in Q4, surpassing expectations for 2023 and finishing off the year with an impressive 23.2% (CAD) gain. To provide some context, US markets are close to their all-time highs recorded in late December 2021. **US equities outperformed other regions in 2023**, with the biggest tech players contributing a disproportionate amount of returns due to the artificial intelligence (AI) trend. The Q4 rally was not limited to the United States, as **all asset classes posted strong returns over the quarter**, showing how pivotal inflation and Fed policy remain for the direction of markets.

The current situation for the Canadian economy is less favourable, with stagnant GDP growth and consumers retrenching from spending in favour of reducing debt. Record population growth in 2023 is unlikely to help with the **shortage of housing that has pushed rents higher**, exacerbating the Bank of Canada's battle against rising prices. Taking all this into account, it is no surprise that Canada's stock markets reacted positively to news of reduced inflationary pressure and the prospect of easier borrowing conditions in 2024. The S&P/TSX Composite Index gained 8.1% in Q4, posting a return of 11.8% for the year.

International markets also notched gains, adding 7.7% in Q4 (15.4% for the year), while emerging market stocks were up 4.1% in Q4 (6.6% for the year). Similar to the situation in Canada, overseas stocks have lagged the United States, as markets there also lack a major technology presence. Emerging markets disappointed compared to other asset classes, as **China's economy has struggled to bounce back** following the country's extended COVID 19 lockdowns and its persisting real estate crisis.

Bond prices rebounded in Q4 as yields fell in anticipation of lower rates. The five-year US treasury yield dropped to below 4%, falling rapidly from just below 5%—a level not seen since 2007. Short-term bonds in Canada were up 4.1% in the quarter and 5% for 2023.

Following are the returns for major indices for the period ended December 31, 2023:

	Q4 actual	YTD actual	1-year actual	3-year annualized	5-year annualized	10-year annualized
Canadian Short Term (FTSE 30-Day T-Bill)	1.3	4.8	4.8	2.2	1.8	1.3
Canadian Bonds (FTSE Short-Term Bond)	4.1	5.0	5.0	-0.1	1.6	1.7
Canadian Stocks (S&P/TSX Composite)	8.1	11.8	11.8	9.6	11.3	7.6
US Stocks (S&P 500)	9.0	23.2	23.2	11.3	14.9	14.5
Non-North American Dev. Stocks (EAFE)	7.7	15.4	15.4	5.2	7.5	6.6
Emerging Market Stocks (FTSE)	4.1	6.6	6.6	-1.8	4.2	5.4

All returns in Canadian dollars. Source: SS&C Technologies and Vanguard.

Outlook

In 2024, investors will also need to assess the economic impact of ongoing geopolitical conflicts and potential administrative changes—**2024 is a record year for elections**, as more than 2 billion voters are set to go to the polls in 50 countries, including the United States and India. History implies that concerns over political events can contribute to **volatility in the short term**. However, rarely is there a lasting impact on financial markets, as investors ultimately focus on the long term.

In the United States, the “Magnificent Seven” tech giants (Amazon, Apple, Alphabet (Google), Microsoft, Meta (Facebook), NVIDIA, and Tesla) **contributed to two-thirds** of the S&P 500 Index returns in 2023. The rest of the market lagged behind significantly due to economic headwinds. This could mean that if the economy proves resilient, there would be room for growth in stock valuations even if the “Seven” take a relative breather. Along with economic readings, action from the Fed, and election results, the **continued emergence of AI** will be a major theme to watch. We expect to learn more about how AI will alter the way we do business and live our lives as well as what the implications are for tech sector investments.

At home in Canada, consensus is that our economy may be weaker in the near term than other developed nations because of **high levels of household debt**. On a per-capita basis, Canadian GDP has declined for five consecutive quarters, and the landscape remains challenging, with the full impact of rate hikes yet to be adsorbed and a significant number of mortgages slated to soon be **renewed at much higher rates**. The expectation for difficult times ahead for the Canadian consumer along with attractively yielding and lower-risk investment options such as GICs and high-quality bonds are factors that weighed down the Canadian stock market last year as a result. But the prospect for lower rates as a policy response from the Bank of Canada as inflation abates and the economy cools could spark renewed interest in Canada’s markets, particularly dividend-paying stocks (e.g., banks, pipelines, utilities) in the coming months.

The relative underperformance of both international developed and emerging market equities in recent years has commentators pointing to the **potential for a rosier outlook** going forward, as these regions could play a game of catch-up. Emerging market economies tend to rely more on debt and so will likely respond well to a lower-rate environment.

Despite all the talk about interest rates coming down and the relief that it will provide, important to note is that we have likely seen the **end of the historically cheap borrowing environment** that emerged from the credit crisis and persisted through COVID 19. It will take some time for consumers, governments, and investors to adjust to the new normal for interest rates, and so volatility across both fixed income and equities should be expected in the near term.

Portfolio Strategy

The possibility of lower interest rates bodes well for stocks going forward. This is especially the case for income-oriented equities such as dividend-paying stocks, as they tend to be the most sensitive to changes in yields. In Canada, dividend-paying stocks have been one of the segments of the market that has underperformed of late. Consequently, **opportunities exist to lock in income streams** at a relative discount before these names fully recover.

Despite their recent run, US stocks could continue to gain in 2024, as the nontech components of the market are still trading at **reasonable valuations** with upside should earnings improve. Also possible is that the AI trend will still be a force in extending the rally this year. Similar to Canadian equities, overseas developed and emerging markets might be poised to bridge their performance gap as price- and rate-related pressures ease.

After a decade of low yields for fixed income, investors are finally being compensated with meaningful returns on the conservative side of their portfolios—a welcome change. Rates across the yield curve have receded but are still well above what we saw during COVID 19, and they aren't likely to decline to anywhere near the same degree, barring another black swan event. For this reason, where appropriate we **continue to build income ladders** using bonds and GICs.

A considerable amount of market volatility has occurred during the past couple of years, and at points, in the absence of a proper strategy, investors may have been tempted to sit on the sidelines through it. However, history has shown that markets tend to snap back very quickly, which makes **attempting to choose the right reentry point a hazardous exercise**. The rapid recovery in Q4 is a great example of this. The US market is now trading above all-time highs set at the end of 2021, and disciplined market participants who stuck to their plan did not need to worry about missing out. At Milestone, we structure portfolios with the appropriate asset mix not only to reflect each client's risk tolerance profile but also to allow them to weather periods of market uncertainty. As always, investment success comes with discounting the short-term "noise" in the marketplace and focusing on longer-term objectives.