MARKET INSIGHTS

PACIFIC LIFE

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Market Review and Outlook

Fourth Quarter 2023

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Market Review

Equity markets bounced higher during the fourth quarter of 2023, with the S&P 500® index up 11.69% for the period as market breadth widened, benefiting recently out-of-favor styles. In terms of size and style, small-cap value performed well after struggling during the prior few quarters. Among domestic equities, large-cap value lagged other styles. Real estate, which had struggled throughout the year, also performed well during the final quarter of 2023. Consistent with much of 2023, international equities continued to lag domestic stocks, particularly as Chinese stocks continued to face multiple challenges.

Within fixed income, longer-duration bonds outperformed their shorter-duration counterparts, as the yield on the 10-year Treasury plunged during the quarter. Among the credit-spread sectors, emerging-markets debt and high yield performed relatively well, while bank loans struggled to keep pace.

Outlook

The Federal Reserve (Fed) paused rate hikes during the last three Federal Open Market Committee (FOMC) meetings of the year. Unless inflation pressures resurface, the Fed is likely finished with its rate- hike cycle. At the time of this commentary, the market consensus suggests that the Fed will pursue interest-rate cuts sooner rather than later, with the first cut coming as early as March 2024. However, this view is based on core inflation heading toward the Fed's target of 2% during the next several months.

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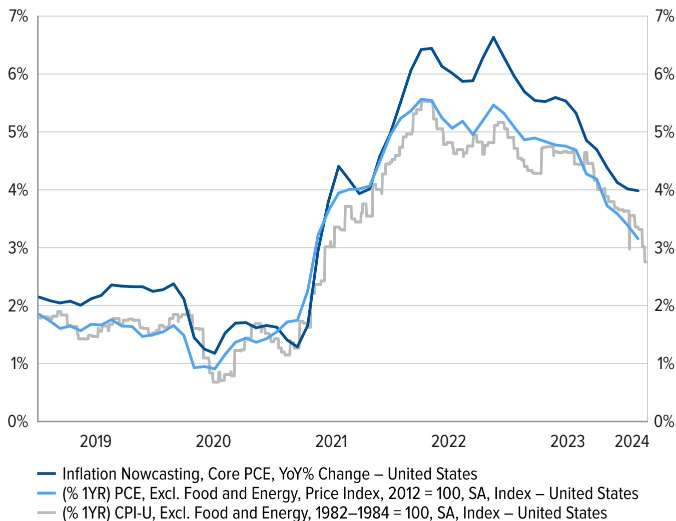
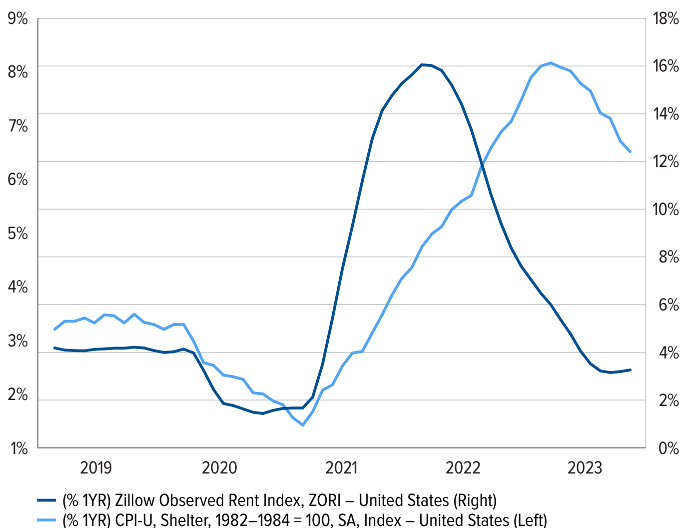


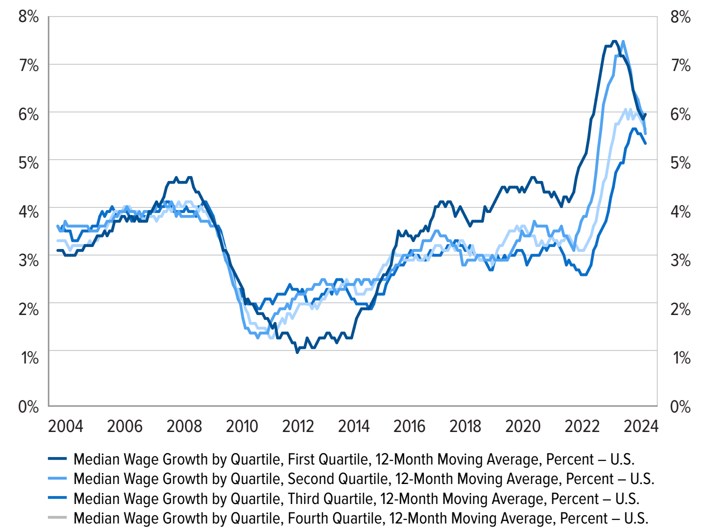
Source: FactSet

According to real-time data tracked by the Fed's Inflation Nowcasting, core personal consumption expenditures (PCE) appears to be on track to hit the Fed's target within the next several months—unless inflation turns out to be stickier than predicted. Nonetheless, this is further verified by already-normalizing market rent prices. Market rent price data (which tends to lead consumer price index (CPI) shelter data by roughly a year) indicates housing inflation has already normalized in real time, implying core CPI and PCE should soon follow.



Source: FactSet

Additionally, while shelter inflation is set to decelerate and normalize, wage growth remains elevated and well above normal levels—though it peaked about a year ago. Wage growth impacts non-shelter service inflation, which should be the last piece keeping inflation elevated. Latest labor-market data suggests employment remains quite strong, which means the market might be too optimistic for early rate cuts.



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The U.S. economy continues to remain relatively resilient despite eleven rounds of interest-rate hikes since 2022. Unemployment remains well below 4% as companies continue to hire more workers. One of the reasons for the resiliency stems from all the government spending aimed to drive infrastructure, electric vehicle, and semiconductor production. Additionally, enthusiasm about artificial intelligence (AI) will likely attract a considerable amount of private capital into its development. All this spending could support the economy and add pressure to inflation.

However, some of these potential pressures could cause the Fed to hesitate from cutting rates too early. Unless these inflationary factors dissipate, the Fed may end up disappointing the market by holding interest rates higher for longer (as Chairman Jerome Powell has suggested before). Additionally, both consumer and corporate confidences have not deteriorated enough to warrant significant cuts just yet.

Furthermore, we cannot ignore geopolitical risks that could potentially reignite inflation. Tensions around the South China Sea have the potential to disrupt global trade, as China continues to flex its military authority in the region and seeks to reunite Taiwan with the mainland. Further decoupling between the U.S. and China would likely have inflationary effects. Additionally, the ongoing conflict in the Middle East and the Red Sea is forcing shippers to find alternate routes within those regions, causing shipping costs to spike again.

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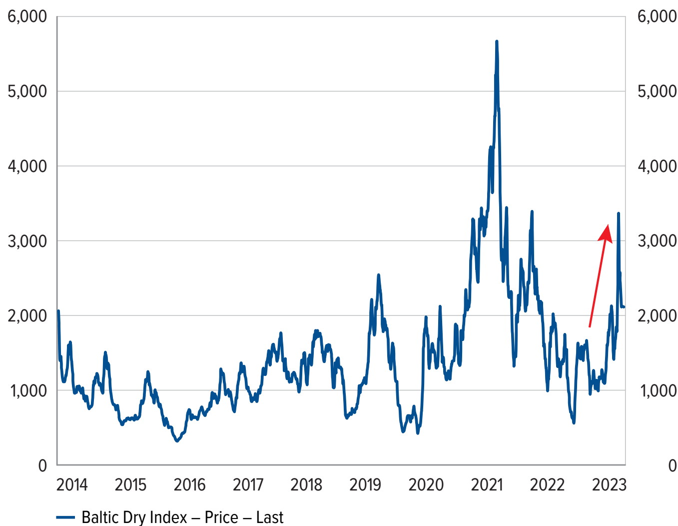

Source: FactSet

Inflationary risks continue to linger, and it may be too early to celebrate now. Current signs indicate the Fed may refrain from aggressively easing monetary policy for the time being—unless FOMC members begin to worry about a hard-landing scenario. Although the Fed may be done raising rates, it may hesitate from cutting rates too early or aggressively given the tapering of deep recessionary risks. With this outlook, it may seem premature to aggressively dial up portfolio risk for now.

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