Quarterly Market Update: First Quarter 2024

Executive summary

THE FOLLOWING IS AN EXECUTIVE SUMMARY FOR THE “QUARTERLY MARKET UPDATE: FIRST QUARTER 2024” REPORT BY FIDELITY’S ASSET ALLOCATION RESEARCH TEAM

Market summary: “Everything” rallied in Q4

Global stock and bond markets rallied powerfully near the end of 2023 after the U.S. Federal Reserve signaled that disinflationary trends were sufficient to project a shift to monetary easing in 2024. As a result, markets begin 2024 with momentum and easier financial conditions.

That said, positive surprises for the economy, disinflation, and Fed cuts may be more difficult with so much good news already priced in.

Large caps led the way: For the full year, U.S. large cap growth stocks led all asset classes, gaining more than 40% in 2023. A dramatic rebound for the stocks of the seven-largest U.S. companies by market capitalization—concentrated in the technology and communications sectors—drove the U.S. equity market’s gain.

Most other major asset classes posted a double-digit gain for the year, including real estate stocks (+13.7%), high-yield bonds (+13.5%), and U.S. value stocks (+11.7%). Commodities were the only major asset category to suffer a loss (-7.9%).

After advancing to nearly a 5% yield in Q3, nominal 10-year Treasury bond yields turned sharply lower during Q4 and finished 2023 in roughly the same place as they began. The substantial decline in real yields—the inflation-adjusted cost of borrowing—drove most of the steep Q4 drop in nominal yields, largely due to investor expectations for future Fed easing.

Economy/macro: A less synchronized expansion

Many major economies, including the U.S., remained in a late-cycle expansion. Global crosswinds included evidence of solid service activity but restrictive monetary policies in many developed economies. The global monetary tightening cycle appears to be over, but the pace and magnitude of easing remains uncertain.
China remained an outlier, as it continued to ease policy in hopes of reaccelerating from its growth slump. Leading economic indicators rose across a majority of the world’s largest economies near the end of 2023, bolstered by services activity. Manufacturing bullwhips—new orders minus inventories—ended the year in positive territory, potentially signaling firming industrial activity.

**The easy disinflation could be done:** Headline consumer price inflation dropped to near 3% toward the end of 2023 from the 2022 peak of 9%. Rapid goods disinflation—from 14% in 2022 to near zero by the end of 2023—contributed greatly to the lower headline number.

That said, a steady decline in year-over-year inflation rates slowed in recent months. Housing services inflation slowed much less than market expectations and disinflation in other services stalled. Consumer expectations for medium-term inflation remained elevated despite the disinflation in 2023.

We believe there is a risk that inflation remains above the Fed’s 2% target absent a greater deterioration in economic activity.

**U.S. consumers remain in solid shape:**
U.S. consumers were supported by real wage gains in 2023 amid a tight labor market and ebbing inflation. Households have generally enjoyed strong balance sheets due to high housing and asset prices, and the long-term, fixed-rate structure of most mortgage borrowing helped insulate them from higher interest rates. However, delinquency rates on more flexible-rate loans moved above pre-pandemic levels.

**A productivity recovery?** Capital expenditures by businesses, boosted by domestic manufacturing and artificial intelligence (AI) initiatives, picked up as 2023 progressed. An acceleration in investment in structures likely reflected the reshoring trend that includes new-factory construction. Productivity growth also recovered, which could signal a bottom after a decade-long slump.

**Market optimistic for earnings recovery:** After dropping from record-high levels, profit margins stabilized toward the end of 2023, leading investors to expect a double-digit rebound for earnings growth in 2024. With margins still at the upper end of their historical range and signs of diminishing pricing power, the ability of companies to maintain or expand margins will be key to the outlook.

**Market liquidity could face pressure:** Major central banks continued to remove accommodation by shrinking their balance sheets through quantitative tightening (QT), which typically reduces financial-market liquidity. In the U.S., less participation in the Fed’s Reverse Repo program injected cash into the system, which more than offset QT in 2023. With this one-off factor closer to being exhausted, the U.S. liquidity backdrop may be more challenged in 2024, potentially contributing to higher volatility.

**Other challenges remain:** Risks to the 2024 outlook include still-tepid global manufacturing activity and the lagged impact of monetary tightening. The medium-term fiscal picture appears increasingly challenging as well, as rising interest payments are forecast to cause deficits to climb over the next decade. Politically, spending cuts have become difficult as mandatory outlays on entitlement programs assume a larger share of fiscal expenses.

**Asset markets: A broad advance**
Most major U.S. and non-U.S. equity categories advanced in Q4. All fixed income categories gained in the fourth quarter and for the year, as did all major international equity regions.

**Stock prices:** For the full year, most U.S. stock sectors rose 10% or more, led by information technology (57.8%) and communication services (55.8%). Less-cyclical sectors, including utilities (-7.1%) and energy (-1.5%), lagged the market rally.

Valuations became somewhat more expensive as stocks rallied in Q4, especially for the U.S. The trailing one-year price-to-earnings (PE) ratio for U.S. stocks stayed above its long-term average while non-U.S. stock (developed markets and emerging markets) valuations remained at or below their long-term averages.
**Fixed income:** After languishing during most of 2023, returns from fixed income assets rebounded during Q4 as yields fell, and riskier credit categories finished as the year’s best performers. High yield (+13.5%), leveraged loans (+13.3%), and emerging markets debt (11.1%) led the way, whereas Treasury inflation-protected securities (TIPS) advanced only 3.9%, amid falling inflation.

**Earnings:** Global earnings growth, which has been decelerating since 2021, continued to show signs of stabilizing during Q4 as the U.S. and developed non-U.S. regions posted flattish year-over-year growth. Emerging markets remained laggards, with a double-digit earnings contraction on a year-over-year basis. Investors anticipate a rebound in earnings growth in 2024 across the world.

**Currencies:** Despite entering 2023 at a relatively expensive valuation, the U.S. dollar was bolstered throughout the year by the solid U.S. growth backdrop. However, the Q4 disconnect between solid relative U.S. growth and weaker dollar performance could imply greater headwinds for the dollar in 2024. Most major non-U.S. currencies, particularly the Japanese yen, remained undervalued, which suggests they might provide portfolio diversification benefits.
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