Quarterly Market Update: Fourth Quarter 2023

Executive Summary

THE FOLLOWING IS AN EXECUTIVE SUMMARY FOR THE “QUARTERLY MARKET UPDATE: FOURTH QUARTER 2023” REPORT BY FIDELITY’S ASSET ALLOCATION RESEARCH TEAM

Market Summary: Rising Yields in Q3 Weighed on Stocks and Bonds
Stalling disinflation, rising bond yields, and an uncertain global economic outlook set the stage for a choppy market backdrop during the third quarter, despite solid economic and corporate activity.

Most stock and bond categories declined, with rising oil prices pushing commodities and energy stocks higher. Bond yields rose above their long-term historical averages causing interest-rate sensitive assets to decline the most. Increased uncertainty about inflation raised the odds of higher market volatility, amid global monetary tightening and dampened market liquidity.

At the end of Q3, many investors expected that global policy rates had reached their peaks and could ease in the coming quarters. That said, the impact of the abrupt departure from the ultralow rates era could still weigh on financial conditions in the quarters to come.

The resilient U.S. late-cycle expansion coincided with a stalling pattern in disinflationary trends, another Fed rate hike, and rising long-term Treasury-bond yields. The late-cycle phase of the business cycle warrants smaller cyclical tilts, long-term portfolio diversification, and a readiness for opportunities.

Economy/Macro Backdrop: An Asynchronous Late-Cycle Expansion
Many major economies, including the U.S., remained in late-cycle expansion. Global crosswinds included evidence of solid service activity in many developed economies. China’s economy appeared to stabilize amid a pick-up in policy easing. Europe lost momentum amid a manufacturing downturn and a rise in oil prices.

Central banks continued to remove accommodation by shrinking their balance sheets during Q3. A more challenged liquidity backdrop may contribute to rising market volatility.
Goodbye to Easy Disinflation?: The easy U.S. disinflation appears to be over. Inflation pressures that tend to be more transitory, such as supply-chain disruptions, continued to fade during the quarter. However, categories where price increases have tended to be more persistent accounted for the bulk of the third-quarter inflation drivers.

Lending Standards Continued to Tighten: The U.S. Treasury yield curve remained inverted and credit standards have tightened. This inverted curve, in conjunction with tight monetary policy, caused banks to tighten lending standards across multiple loan categories for the fifth consecutive quarter.

The Impact of a Rising Cost of Capital: So far, the U.S. economy has proven to be less rate sensitive and been able to weather this cycle’s rate hikes. Many consumers are locked into long-term fixed-rate mortgages at super low rates and large companies have issued low-rate long maturity bonds. Smaller businesses, which tend to have variable-rate, shorter-maturity debt, may be particularly exposed to this threat.

Asset Markets: A Risk Rally Interrupted
Most major U.S. and non-U.S. equity categories had negative returns in Q3. Most fixed-income sectors drifted lower as well. Stocks and bonds were positively correlated, challenging portfolio diversification. For the full year, U.S. stocks remained on top with solid gains, while high-quality bonds dipped into negative territory.

Stock Prices: The 2023 market rebound remained narrow. The 10 largest stocks in the S&P 500 index, concentrated in the technology and communications sectors, have accounted for the bulk of the market’s gain so far in 2023. The appreciation in valuation multiples year-to-date has propelled the market’s rally, even as earnings growth has declined.

Fixed Income: After many years of very low bond yields and tight credit spreads, fixed income assets offer relatively better income opportunities with more attractive valuations. U.S. Treasury yields reached their highest levels since 2007, supported by the Fed’s monetary tightening, persistent inflation, and increased market expectations for a soft economic landing.

Earnings: Global earnings growth, which has been decelerating since 2021, showed some signs of stabilizing in the third quarter. Earnings growth expectations for the next 12 months remain positive across the world.

Currencies: Stronger U.S. cyclical growth trends relative to the rest of world imply a more favorable medium-term outlook for the dollar and could explain some of its recent outperformance. At the end of Q3, non-U.S. currencies appeared undervalued relative to the dollar, suggesting that non-U.S. currencies may provide longer-term potential upside and portfolio diversification benefits.
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Fidelity Thought Leadership Vice President Mike Tarsala provided editorial direction for this article.