

## Recap of 2023: Two Stories With The Same Ending

As we approached the end of 2023, we witnessed more optimism about the US economy and further stock market gains until a sharp pullback snapped the US market's nine-session winning streak. Nevertheless, the S&P 500 posted its eighth week of gains after US inflation data showed a gradual economic cooling in line with Fed hopes.

Overall, after a turbulent 2022, global equities ended 2023 year up around 23%, driven by a staggering rebound among technology and other growth stocks, epitomised by the so-called "Magnificent 7" mega-cap tech giants like Apple, Microsoft and Nvidia. The last stock more than tripled over the year, lifted by surging demand for AI and data centre infrastructure. Cooling inflation and the lack of a much-vaunted recession also helped, although gains outside the 'Mag 7' and the US IT sector were for the large part much more muted, and 2023 was essentially a year of dramatic polarisation in markets and volatility in bond markets.

On the one hand, the tech-heavy Nasdaq index finished the year about 50% higher. On the other, Chinese and Hong Kong equities suffered double-digit declines as China's economy's post-COVID reopening faltered, and the over-leveraged property market hit a wall. The Eurozone proved surprisingly resilient, with the Euro Stoxx 50 up over 23% thanks to energy security and falling gas prices. Meanwhile, UK markets lagged with the FTSE 100 Index gaining only 7.9% in GBP terms, weighed down by political and economic uncertainty. Perhaps the most fundamental success story was Japan off the back of strong earnings and a cheap valuation starting point that has started to rerate, no doubt helped along by interest from a certain Mr Buffet.

The Australian market delivered a solid 12.1% return in 2023, led by strength in materials and financials – the two heavyweights of the index. The banking sector proved resilient, gaining 11% despite contagion fears following the US regional bank crisis. Resources delivered 15% returns as commodity prices held firm. By contrast, healthcare and utilities lagged with low gains year-to-date. Larger cap stocks generally fared better than small caps - the ASX 50 rallied over 13% while the Small Ordinaries index was up a more modest 7.8%. This divergence saw the Australian market driven by its core sectors of financials and miners, while more domestically exposed businesses struggled amidst inflationary pressures and rate hikes.

As the story of this rate hiking cycle has turned a corner towards the end of 2023, with cuts seemingly around the corner, fixed interest markets delivered. Australian fixed interest was

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behind the returns offered internationally, gaining 5.1%, owing to the slower rate of change in policy rates. Global credit returned 7%, which seems like a pretty good performance, especially compared to recent years, but not significantly in front of global treasuries which were strong at 5%, while high-yield bonds gained 11.3%, supported by rising yields and the lack of a catastrophic credit crunch that many may have expected earlier in the year.

It hasn't all been smooth sailing, as early in the year a shock crisis among cryptocurrency and tech-exposed US regional banks led to bailouts from the Fed and larger peers, while Israel's declaration of war against Hamas in October increased instability.

Overall, the US Federal Reserve can be credited with fighting off inflation and, in the last few weeks, pivoting from aggressive rate hikes to flagging potential cuts by mid-2024 in a bid not to repeat the mistakes of the recent past (namely holding on to the view of transitory inflation too long). This time they want to avoid overtightening after the inflation pulse has finally passed through the system. The cooling of price pressures has also revived consumer and business confidence and given credence to the notion of a soft landing in 2024.

The outlook for Australia is more nuanced with inflationary pressures still present, but the RBA has arguably also played a deft hand by avoiding the extent of rate rises seen in the US and thereby avoiding a precipitous collapse in the local housing market. That is the widely accepted view of what happened in markets in 2023 and it is a fairly credible and largely accurate narrative.

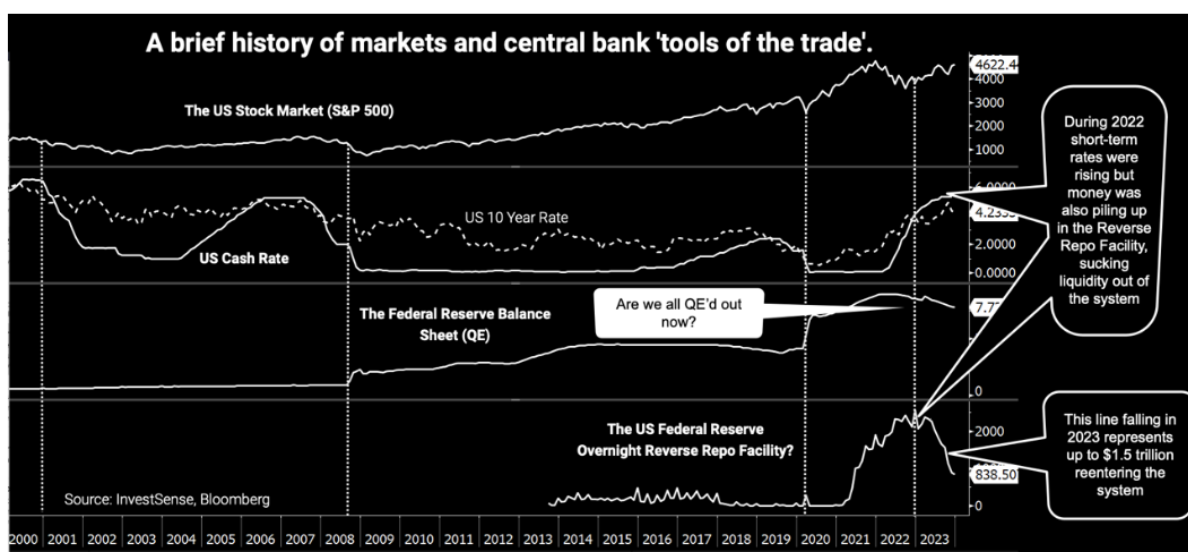
The classic 1950's Japanese film *Rashomon* depicts a murder from differing, subjective perspectives. Despite the contradictory accounts, the film comes full circle to reveal the truth with the same climactic ending. More recent films like *Hoodwinked* or *Courage Under Fire* used the same effect to illustrate how the same story can be perceived entirely differently while still leading to the same unambiguous, if somewhat disillusioning, truth in the end. If we were to 'Rashomon effect' the market story of 2023 we would invoke more of Andrew Hunt's analysis (discussed in last week's video). Through that lens, the market rally of the last year could have been purely down to trends in liquidity and availability of credit, rather than just narratives about economic performance. There is a long history of major rallies being fuelled by abundant liquidity and loose credit conditions, often alongside positive but hard-to-quantify stories (like AI-driven productivity gains).

Earlier in the year amidst the Silicon Valley crisis, and then more aggressively in recent months, both the Fed and BoJ have flipped to more accommodative monetary stances, despite questionable evidence of genuine economic weakness. At the same time, data

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shows a massive expansion in USD liquidity and bank lending to hedge funds and others. Property prices are also on the rise again globally. At the centre of these massive shifts in liquidity is the Fed's Reverse Repo Facility and with every day that passes it becomes more evident how important a \$1.5 trillion increase in market liquidity might have been.

This flood of liquidity into asset markets, rather than real improvement in growth prospects, may better explain the dramatic rebound across stocks, bonds, and property. It echoes similar liquidity-driven booms in the past – whether the UK market surge of 1987 amid 20%+ money supply growth or the 1990s Japanese bubble justified by vague talk of land shortages. The risk is that, just as in 2020-21, central bank liquidity injections now simply set the stage for another surge in inflation later, perhaps from mid-2024. Global inflation expectations have already started ticking higher again. If so, policymakers may be forced into another hawkish reversal after having encouraged renewed speculative excess.



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Now of course the economy in the US has performed much better than expected, but that in turn is probably has the same source material – excess savings left over from COVID era stimulus.

So, while narratives matter, the more prosaic expansion of credit and loose monetary policy arguably better explains this rally overall, if you had to choose one narrative. Such liquidity-driven gains can persist for some time. But if inflation re-accelerates as a result, it may end the party later next year. So, liquidity trends and financial conditions warrant close attention even as stories about growth trends dominate the headlines.

The point about the Rashomon effect is that, ultimately, the narrative doesn't really matter as you inevitably end up at the same point when the truth (economic reality in this case) becomes obvious. In that sense, we will find out soon enough what the objective truth is, but either narrative will suffice when talking to your clients. We suspect that the first version is a bit easier to explain but maybe when thinking about portfolios we should bear in mind what might happen when the stock pile of reverse repo cash runs out in the first quarter of next year.

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