CIO expects financial markets to start the new year with relatively favorable economic conditions, but it is too optimistic to expect immaculate disinflation to continue without frequent market inflections. (UBS)

Lessons from 2023: A year of inflections

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Stocks are approaching the end of 2023 on a strong note, with the S&P 500 hitting a closing high for the year on Friday. The index has now advanced for each of the past six weeks.

With just three weeks left of the year, we believe it is helpful to look back on what we expected to be "A Year of Inflections," the title of our 2023 outlook. There have indeed been numerous inflection points across financial markets this year, many just in the past few months. Most critically, inflation has started to move decisively lower. US growth and monetary policy also appear headed for a turning point, though at least two quarters later than we expected.

Assessing how evolving macroeconomic conditions impacted market performance this year leaves us with several lessons.

The first is that the sequencing of economic developments mattered a great deal for market performance. A year ago, we argued that the medium-term outlook ultimately hinged on a "race to the bottom" between growth and inflation. While we expected growth to slow early in 2023 and were thus cautious on US risk assets at the start of the year, if inflation could credibly race growth to the bottom, a better market regime could emerge in 2023 after a difficult 2022. That's exactly what happened and then some: inflation fell steadily (headline and the core consumer price index went from 6.5% and 5.7%, respectively, in December 2022 to 3.2% and 4% in October) as growth stayed resilient (the unemployment rate rose from 3.5%in December 2022 to 3.7% last month).

The second lesson is that when the macroeconomic environment is highly uncertain and investor conviction on what's going on in the economy is low, it only takes a few data points to prompt sizable swings in expectations for a recession compared with a soft landing. Soft landing expectations were already building in early July, but below-consensus June CPI was the capitulation point for many investors. The same dynamic occurred in November when October

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CPI data was far better than expected. Similarly, implicit recession probabilities surged after the banking crisis in March and after the 10-year Treasury yield flirted with 5% in October.

Applying these two lessons gives reason to be both cautious and optimistic on the markets at the start of 2024. The reason for caution is that another market inflection could occur, with equities and other risk assets turning down again, though likely with rates also falling. In particular, a couple of weak labor market reports in the first quarter of 2024 with the monthly job creation rate falling below 50,000—would challenge the consensus faith in a soft landing. The reason for optimism is that the data for at least the next month could continue to exhibit that ideal combination of ongoing disinflation and resilient growth for markets to keep rallying.

So, while we expect financial markets to start the new year with relatively favorable economic conditions, it is too optimistic to expect immaculate disinflation to continue without frequent market inflections, in our view. Markets are likely to remain rangebound, even if the range for equities has shifted higher, until the Federal Reserve is cutting rates and the other side of the growth slowdown is within sight. That's why we continue to recommend quality bonds and equities. Any inflection on that investment guidance will have to wait until 2024.

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