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Looking Back and Forward

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As investment practitioners schooled in behavioral finance, we know that inherent human biases can form dislocations in markets, which over the medium term create opportunities and risks. A tendency to extrapolate the recent past is one of the more common and persistent of those biases.¹ As we start 2024, with a nod to that bias we look back at some of the key features that worked within equity markets during 2023 and highlight what we are looking out for in 2024.

Looking Back on 2023

The headline grabbers for 2023 in equity markets were the “Magnificent Seven,” the seven largest technology-enabled, US growth stocks that contributed almost half of the total return of the MSCI World Index over the year. We have written in the past about the risks inherent in concentrated markets, and how exposed investors may be if the trend reverts.

We are strong believers in the benefits of diversification over the long term and hold dear the quote attributed to Harry Markowitz that “diversification is the only free lunch in investing.” Yet it is critical to consider the investment horizon for investors. While diversification is beneficial over the long term, last year’s investors would have been rewarded for concentrating in the small subset of quite similar mega-cap names, buoyed by the growth and artificial intelligence memes.

So dominant were the returns of these stocks that, not surprisingly, US equities significantly outperformed the rest of the developed world, bringing the total return of the MSCI World Index to 24% for the year. By contrast, emerging markets lagged significantly, dragged down by China which fell by 10% over the year, driven largely by the disappointment in the re-opening story, sluggish growth, and disturbances in China’s real estate market.

At an equity factor level, Growth and Quality, as defined by their MSCI World indices, trounced Value. Momentum was also weak as markets oscillated around the evolving inflation and interest rate narratives. Low Volatility as a theme underperformed through most of the year, especially in the risk-on rally of the final quarter when investors embraced the full likelihood of a soft landing in the US.

Figure 1
**2023 Returns Relative
to MSCI World Index
in 2023***

Asset Class/Index	Type	Relative Return
MSCI World Index	Equity Markets	24%
NASDAQ 100 Index	Equity Markets	
MSCI USA	Equity Markets	
MSCI Pacific	Equity Markets	
MSCI EAFE	Equity Markets	
MSCI Europe	Equity Markets	
MSCI EM (Emerging Markets)	Equity Markets	
MSCI China	Equity Markets	
MSCI World Index Growth	Equity Factors	
MSCI World Quality	Equity Factors	
MSCI World Small Cap	Equity Factors	
MSCI World Value	Equity Factors	
MSCI World Momentum	Equity Factors	
MSCI World Minimum Volatility	Equity Factors	
Iron Ore	Macro	
LBMA Gold Price PM (\$/ozt)	Macro	
Bloomberg Global High Yield	Macro	
US Benchmark Bond — 10-Year	Macro	
Bloomberg Global Aggregate	Macro	
United States Dollar Index	Macro	
Crude Oil WTI	Macro	
Bloomberg Commodity Index	Macro	

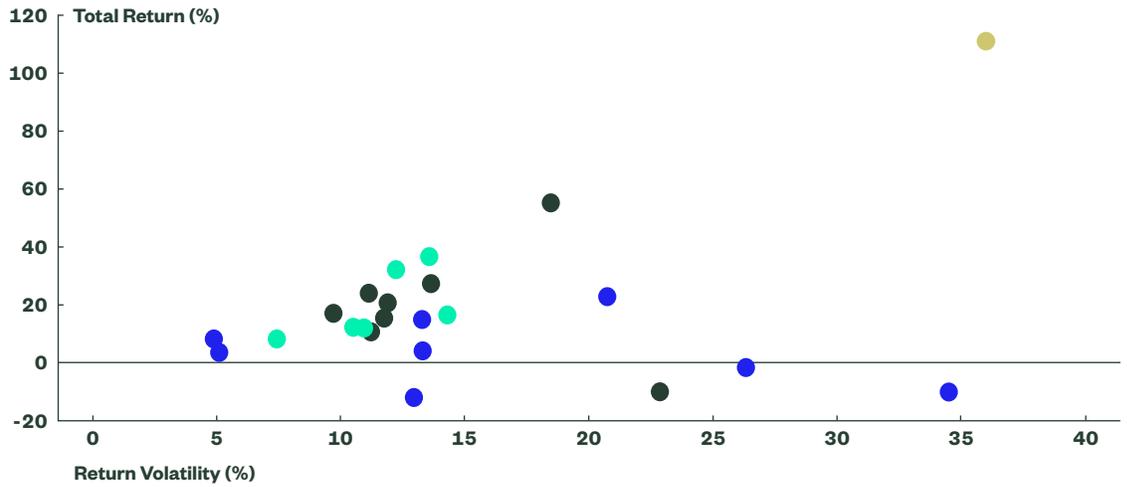
* Returns for select equity markets, factors, and assets.
Source: MSCI, Bloomberg, FactSet, State Street Global Advisors. Data as of December 31, 2023.

Macro-driven markets such as commodities and fixed income tended to lag equities. Despite the rotating market narrative over the year, which saw several gyrations in bond yields (and equity returns), the yardstick US 10-Year Treasury Bond Yield ended the year almost exactly where it had started.

More broadly, investors were well rewarded for taking risk last year, with a strong correlation between market returns and volatility over the year (Figure 2). Equities outperformed with the higher risk markets and factors leading the way, with China standing out as a notable exception. Lower risk equities significantly lagged, with the MSCI World Minimum Volatility Index, for example, underperforming the World Index by 16%.

Figure 2
Asset Return and Volatility in 2023

- Equity Markets
- Equity Factors
- Macro
- Magnificent Seven



Source: MSCI, Bloomberg, FactSet, State Street Global Advisors. Data as of December 31, 2023.

Looking Forward

Headline equity market returns surprised many market participants last year, as interest rate expectations, inflation, and artificial intelligence themes dominated the investment landscape. If those dominant themes settle this year, we believe company fundamentals and valuations will become important to investors once more, rather than a simple continuation of the market dynamics of 2023.

The key winners of last year sit at a valuation premium to the rest of the market, which may be hard to justify as markets normalize. The US equity market finished the year trading at a price-to-earnings ratio of nearly 20 times next year's earnings, compared to 13 times for Europe and only 12 times for Emerging Markets. The average P/E for the Magnificent Seven increased from 24 times to 32 times over the year, despite realizing strong earnings growth. Extrapolating last year's market action would lead to valuations in nose-bleed territory.

Another common behavioral bias of investors is overconfidence. Market action across different asset classes over the final quarter of last year suggests that market participants have now aggressively and confidently moved en masse to believing the soft landing narrative in the US. This move was strongly supportive of equity markets and the risk-on, pro-growth theme.

We remain cautious of extrapolating 2023 returns through 2024. Markets and companies continue to balance the possibility of a soft landing in the US with the very real uncertainties around the timing and the path of interest rates, and the slowly accruing consequences of higher-for-longer rates on companies and consumers worldwide. In this environment, equity market returns are less likely to mimic 2023, and we believe a focus on higher quality companies and valuations will matter for investment returns going forward.

The Bottom Line

As central bankers and market participants remain data dependent, the macroeconomic and market outlook for 2024 is still uncertain. We think betting on a single outcome, particularly a consensus, pro-risk one is not prudent, especially in this environment. We are wary of extrapolating last year's returns and justifying them as the new normal, and so therefore, we look for diversification as a key element in our investment approach. Out-of-favor factors, such as Low Volatility, Value, and small-caps, can have a place in a diversified equity portfolio. In addition, we see potential in regions and sectors that have been left behind in the 2023 market rally. Above all, as we move forward through this year, we believe a careful assessment of risks as well as a nuanced, multi-faceted view of potential returns should be an important part of the overall investment equation.

Endnote

1 Known as the recency bias.

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* Pensions & Investments Research Center, as of December 31, 2022.

[†] This figure is presented as of December 31, 2023 and includes approximately \$64.44 billion USD of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated.

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