

FINANCIAL MARKETS AND THE ECONOMY IN 2023

Interest-rate obsession

In 2023, all eyes were on monetary policy. It turned out to be a wonderful illustration of short-term noise.

At the outset of 2023, the long-predicted recession had yet to materialise. The main concern was inflation, which due to the Ukraine war and supply-chain bottlenecks had shot up and threatened to become entrenched. This had brought about a massive rise in interest rates, with the Fed Funds rate being hiked from zero to 4.25% and the yield on US 10-year US treasuries rising from 1.51% to 3.88%. How high would rates go?

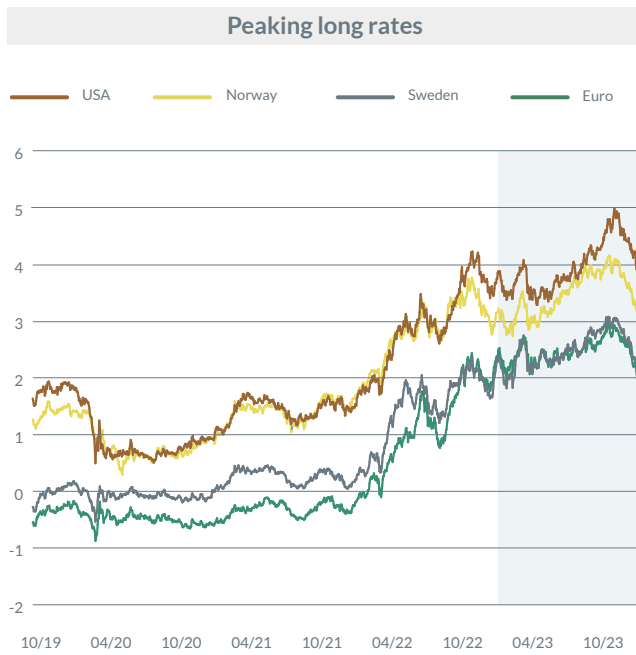
Indeed, the rise continued for a couple of months into 2023. In March, losses on long-dated bonds reached such a magnitude that it led to a collapse in several US regional banks, which had to sell bonds at a loss to finance withdrawals. Shortly thereafter, Swiss banking giant Credit Suisse failed to survive as an independent bank.

The turmoil in the banking industry subsided, but the market did not become less sensitive to interest rates. The correlation between monthly changes in the US 10-year yield and the S&P 500 was a remarkable -0.78 this year, meaning that stocks systematically fell in months when interest rates rose, and vice versa. In 2022, it was -0.53 and in 2021 only -0.18. Even the STOXX Europe 600, logically more independent of US interest rates, had a similar correlation of -0.63 last year.

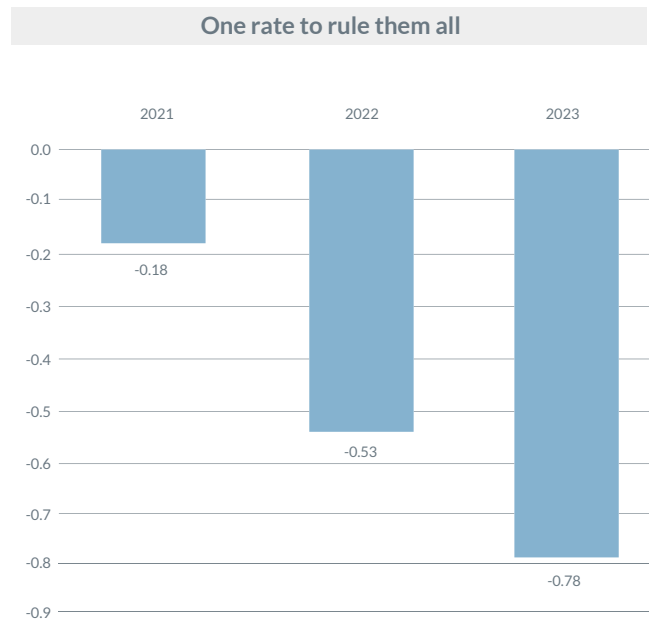
In a fascinating twist of fate, however, the US 10-year yield ended the year exactly where it started: 3.88%.

A SUDDEN CHANGE OF SENTIMENT

Admittedly, interest-rate sensitivity is nothing new. Regressing US stock indices on the past month's changes in the US 10-year yield over the past 20 years, I found that a one percentage



Yield to maturity, 10-year government benchmark bonds. Source: FactSet

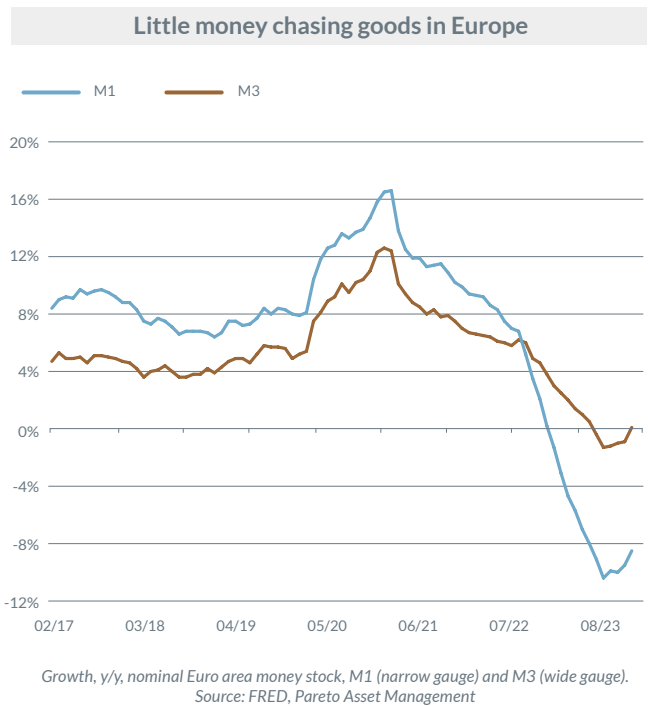
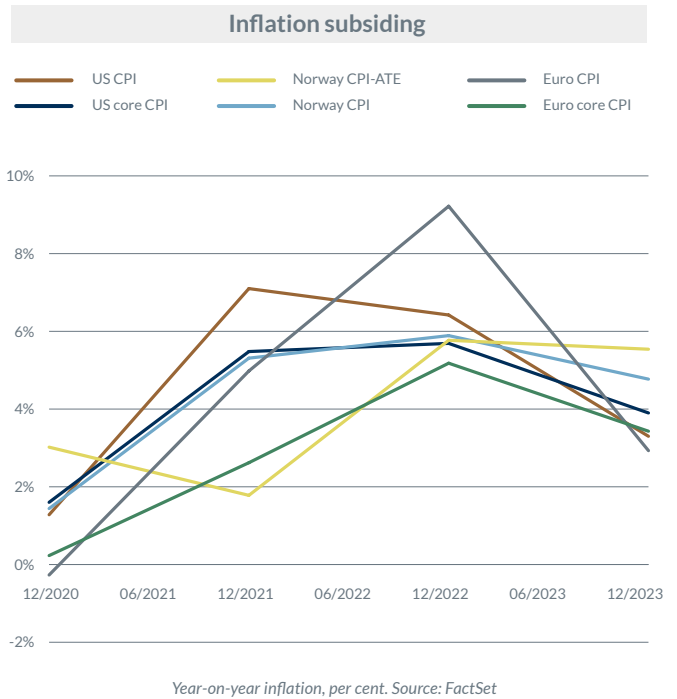


Correlation, monthly S&P 500 returns and changes in the US 10-year government yield. Source: FactSet, Pareto Asset Management

point increase in the interest rate was associated with negative returns the following 12 months of 4.8 per cent for the S&P 500 and a full 20.3 per cent in the Nasdaq Composite, respectively. With the large hikes in key rates starting in 2022 and the uncertainty as to where this would stop, no wonder markets were restive.

In October, the US 10-year yield almost reached 5%. By that time, losses in US government bonds had recorded the longest stretch of losses since 1787, according to Bank of America. The S&P Treasury Bond 10+ Year index, measuring total return in US treasuries with a maturity of at least 10 years, was down by more than 46% since August 2020. To wit: There's more to risk than credit risk.

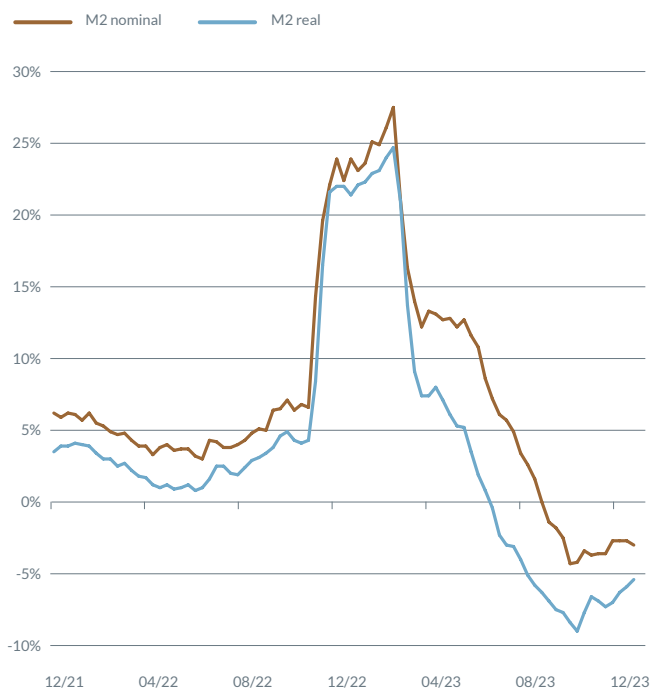
Meanwhile, the term spread had stayed negative, meaning that the most classical of recession indicators kept flashing "recession" for the US economy. At the time of writing this analysis, it still does, although no recession seems to be lurking in the near future. Admittedly, both Germany and Sweden suffered a slight GDP decline last year, but US growth – for which this term spread is relevant – actually increased to 2.5%.



Market rates did not go higher, however. At this point, headline inflation figures were coming in at more encouraging levels, with core inflation starting to follow. Falling money supply in both the US and Europe indicated more to come. Despite core inflation still lagging a bit, it started to look like key rates might peak or had peaked already.

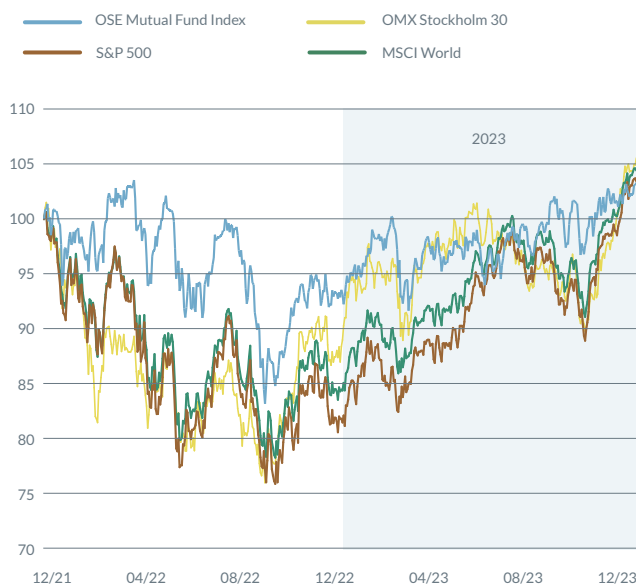
And markets certainly took notice. The US 10-year yield fell by more than a full percentage point before the year was through, while high yield spreads fell by some 1-1.5 percentage points on both sides of the Atlantic. Stock markets raced to end the year at +26% for the S&P 500 and +24% for the MSCI World index. An oil price decline from \$86 to \$77 contributed to a more modest return of 10% for the Norwegian benchmark index.

Little money chasing goods in the US



Growth, y/y, US money stock. Source: FRED, Pareto Asset Management

Extraordinary returns – or just catching up?



Total return indices, rebased, 12/21 = 100, in local currency (so not to be compared for a single investor). Source: FactSet, Pareto Asset Management

ALL-TIME HIGHS AND DIVIDES

Before you draw some conclusions about elevated levels in the stock market, please remember that last year’s appreciation came on the back of a rather bearish 2022. For the past two years combined, the S&P 500 has an annualised return of only 1.7%. The Norwegian Mutual Fund Index has returned 1.6%.

Longer-term, of course, returns are impeccable. In Norway, the long retired “totalindeksen” would have passed the once almost unimaginable limit of 10 000 in 2023, according to our calculations. It was set to 100 at the beginning of 1983 and has since delivered an annualised return of 12%, or 8.6% after inflation. Yes, these decades may have been unusually benign, but using MSCI country indices starting at the outset of 1970, we find an average compound return of 10.6% for Norway and 10.4% for the MSCI World Index. For the Nordic countries index, the average return is as high as 12.9%.

In recent years, the growth/value divide has been a distinguishing characteristic. After a dismal year for growth stocks in 2022, they came back with a vengeance. In 2023, the MSCI World Growth Index returned an impressive 36.5%, versus 11.9% for its MSCI World Value Index sibling.

For both years combined, however, the value index accumulated a return of 8.2%, while the growth index recorded a loss of 0.8%. That’s a fascinating reminder to look beyond short-term returns in the stock market.

This used to be a mirage



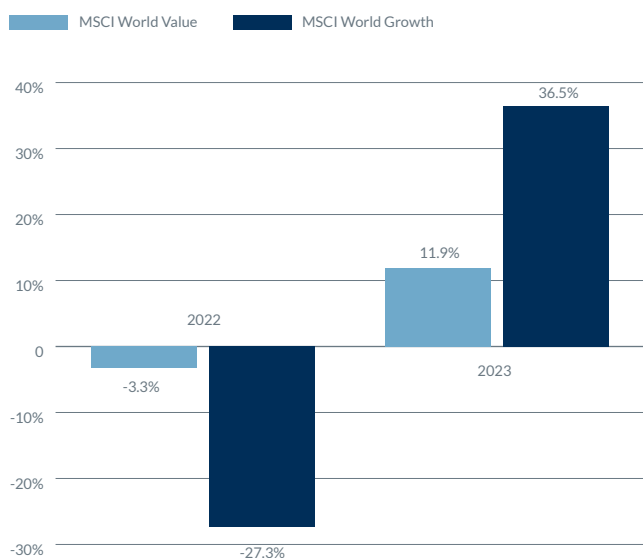
Former “totalindeksen” (TOTX) chained with the all-share index (OSEAX). Source: Oslo Børs, Pareto Asset Management

LARGE HAS BECOME BEAUTIFUL

Lifting our gaze helps us spot longer-term trends. Like this one: The once firmly established small-cap effect has not only disappeared; it has gone firmly into reverse.

For a long time, small caps delivered notable excess returns, so much so that it was classified as a risk factor in order to save the concept of market efficiency. And it stayed that way for quite some time. If, at the outset of this millennium, we invested an equal amount in the S&P 100 (large cap) and the

Massive investment style reset

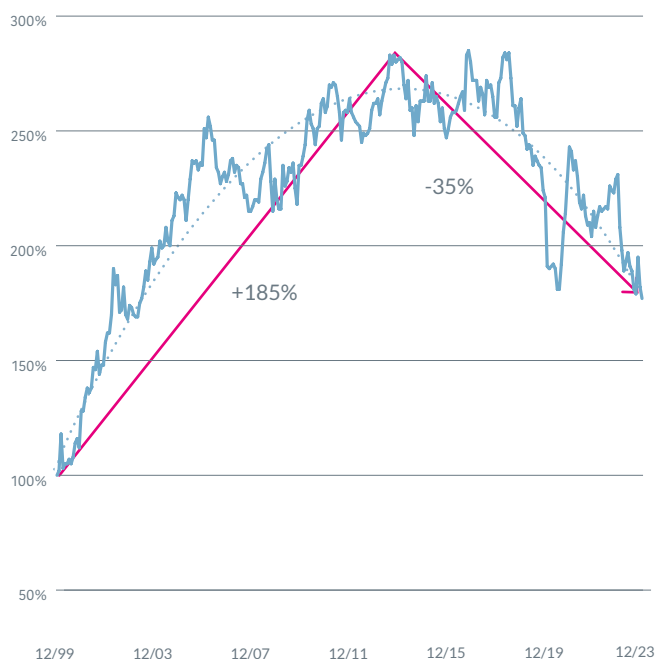


Total return in local currency. Source: FactSet

S&P Small Cap 600 (self-explanatory), the value of the small-cap part would have reached almost three times the large-cap value some ten years ago.

Today, this relationship is truly turned on its head. A similarly paired investment ten years ago would have seen the small caps end up 35 per cent lower than the narrow large-cap leg.

Small size effect in reverse



Index, December 1999 = 100, S&P Small Cap 600 divided by S&P 100, both total return indices. Polynomial trendline added. Source: FactSet, Pareto Asset Management

If instead we use S&P 500 as a large-cap gauge, the difference is somewhat lower – but still a noticeable 30 per cent.

Such is the case in Norway too – only even more pronounced. Here, the small-cap advantage peaked already in November 2008, in the middle of the Great Financial Crisis. Over the ensuing 15 years, small caps lost a full 61 per cent relative to the benchmark index.

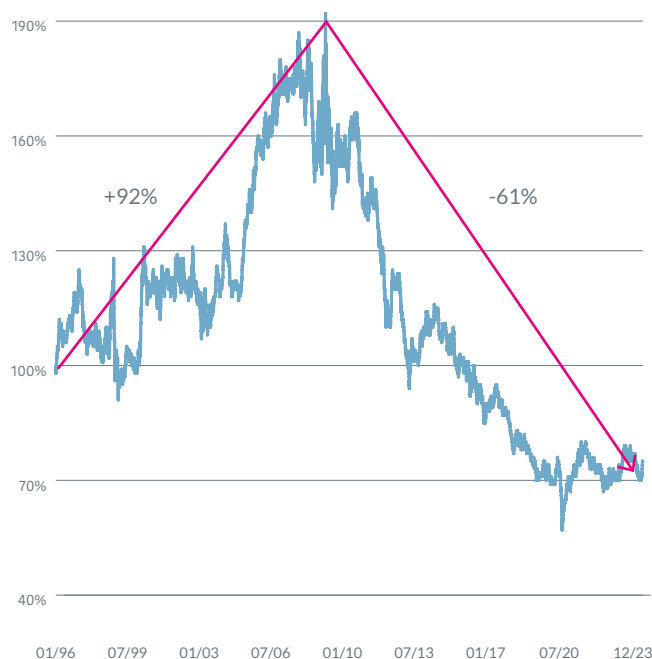
Too many numbers? Here's a simpler conclusion: Over the past 10-15 years, large stocks have outperformed small stocks by a considerable margin – with the opposite sign of what all textbooks will tell you.

A not so small part of the blame, if you like, goes to «The Magnificent Seven»: Alphabet (Google), Amazon, Apple, Meta, Microsoft, Nvidia and Tesla. In 2023, they lifted both large caps and growth stocks. They also made it very hard for active managers to produce excess returns. The top seven stocks in the S&P 500 now make up about 28% of the total market cap, a concentration not seen for more than 40 years.

THE WEIGHT OF A NEGATIVE CARRY

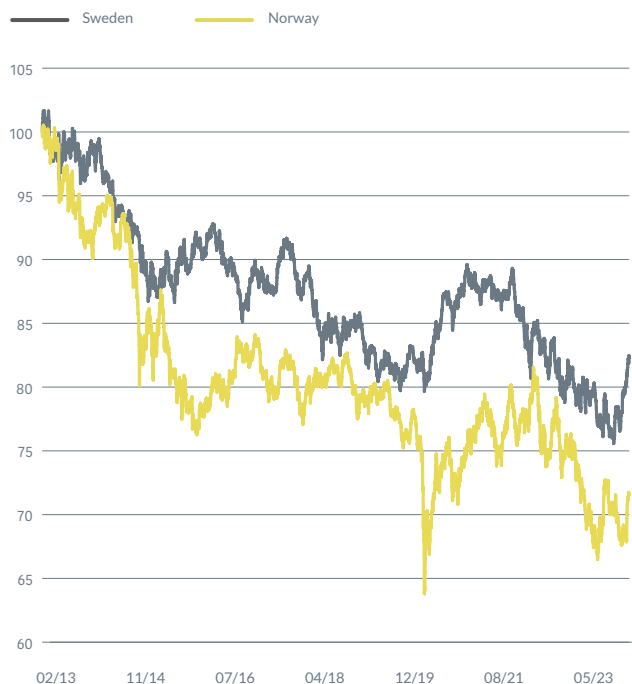
For Norwegian investors, stock returns from global investments have long been lifted by a steadily weakening Norwegian krone. The international value of the Norwegian krone (the effective exchange rate) has fallen by some 30 per cent over the past decade, or just shy of 25 per cent if we adjust for inflation differentials (the real effective exchange rate). It fell last year, too, just as Norges Bank was busy fighting inflation and concerned about the inflationary impulse from a weak currency.

Small stopped being better 15 years ago



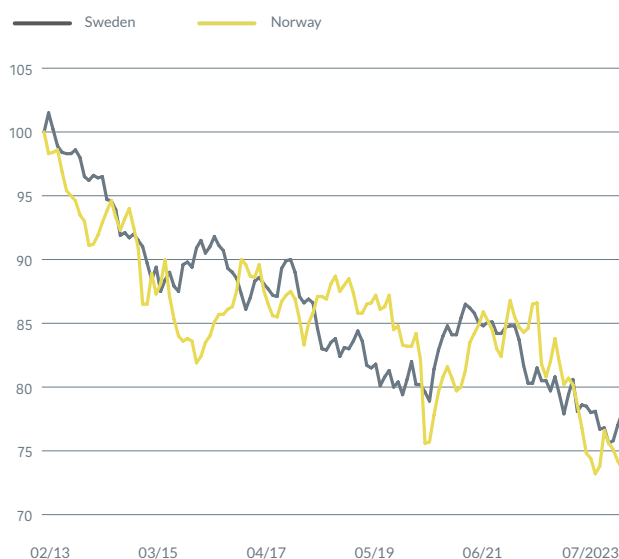
Index, December 1995 = 100, the OSE small stock index (OSESX) divided by the benchmark index (OSEBX). Source: Oslo Børs, Pareto Asset Management

Steadily depreciated



Nominal effective exchange rates, February 2013 = 100.
Source: OECD, FactSet, Pareto Asset Management

Really depreciated



Real effective exchange rates, end of February 2013 = 100.
Source: OECD, FactSet, Pareto Asset Management

This is where interest rates come into play. Over the past 15 years, there is a strong correlation – in excess of 0.8 – between the USDNOK rate and the interest differential on short maturities (both 1 and 2 years). There's a similar pattern for Swedish kroner, by the way, but we'll limit ourselves to Norway here. A simple regression indicates that this interest rate differential, the carry, explains almost 70 per cent of the variation in the USDNOK rate. The effect is highly significant. Statistically speaking, the oil price actually turns out to be redundant.

Presently, the carry is negative; rates are higher in the US. This goes for both key policy rates and market rates. At the very least, Norges Bank will hardly want to see an even more negative carry, meaning that they will, or should, delay cutting the policy rate at least until the Federal Reserve does. ECB policy decisions are not irrelevant but, historically, dollar rates seem to matter more than euro rates.

So ... not only are expected rate cuts from the Federal Reserve pushed further into the future. On top of this, Norges Bank will probably have to be even more patient.

GOOD PROFITABILITY DESPITE MODERATE GROWTH

For Norwegian industries, the further weakening currency was a powerful stimulus, fuelling profitability in export industries like seafood. On the other hand, lower prices on oil and especially natural gas had negative ripple effects on the mainland economy. With or without the oil sector, GDP growth was barely positive in 2023.

Advanced economies as a whole did better, with a weighted average of 1.6 per cent, according to the January update from the IMF. This was above estimates published only a few months before, in October. Meanwhile, 2024 growth estimates were also raised, indicating increased optimism at the end of a somewhat mediocre year in GDP terms.

It's the carry, stupid!



Correlation full series: -0.83 Correlation last 3 years: -0.88
Source: FactSet, Pareto Asset Management

Profitability, however, was generally good in the stock markets we follow. For the S&P 500, earnings per share are now some 40 per cent higher than before the pandemic, while estimates for the next 12 months are 6-7 per cent higher than one year before. Broad European indices display similar figures. As earnings growth goes, this is not impressive, considering that early estimates tend to be cut as the actual period approaches. But it isn't anywhere near signalling a recession. For the S&P 500, it is higher than the estimated earnings growth one year earlier. Norwegian figures tend to fluctuate with the oil price, and so the estimate here points to a slight reduction in earnings.

LIQUIDITY KEEPS FLOWING

In the stock market, liquidity is key. And for liquidity, the US market is key. From the fourth quarter of 1996, when then Federal Reserve Governor Alan Greenspan held a speech on "irrational exuberance" and the Fed started keeping score, close to \$17 000 billion have been paid out through share buybacks or mergers and acquisitions from non-financial corporations. Only the cash part of the transaction paid by US acquirers is included in the latter figure.

During the same period, approximately \$9,900 billion have been paid in through equity issues. In other words, the net effect of all equity transactions is an aggregate liquidity supply of more than \$7 000 billion. And I still haven't mentioned dividends, which – at an estimated \$13 500 billion – bring the net grand total to more than \$20 000 billion. This enormous supply of liquidity must have been instrumental in propping up stock market liquidity – and prices – not only in the US market.

Logically, neither buybacks nor M&A activity is unrelated to the level of interest rates. While both have been decreasing during the past couple of years, buybacks are still above pre-pandemic

levels and the net effect is squarely in the positive. A prolonged period of higher interest rates may of course affect this picture.

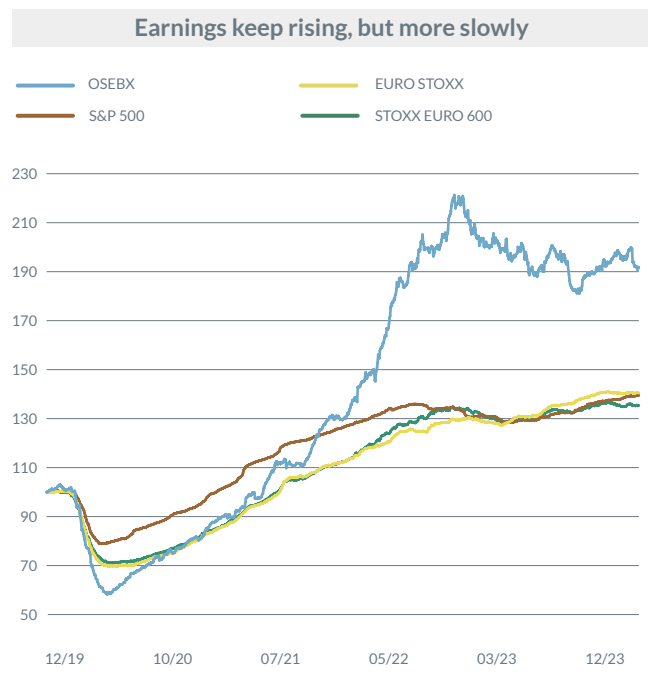
GAS ANXIETY DISAPPEARING ALTOGETHER

Further reductions in interest rates will require more solid proof that inflation is under control. Evidence may be building through concurrent readings, but core inflation is stickier and further reductions are not a given. Supply chains may once again become an issue, as shipping through the Suez Canal has been impacted by the war in Gaza, leading to longer shipping routes and higher rates. In the case of more lasting disturbance, it is unlikely that inflation will not be affected.

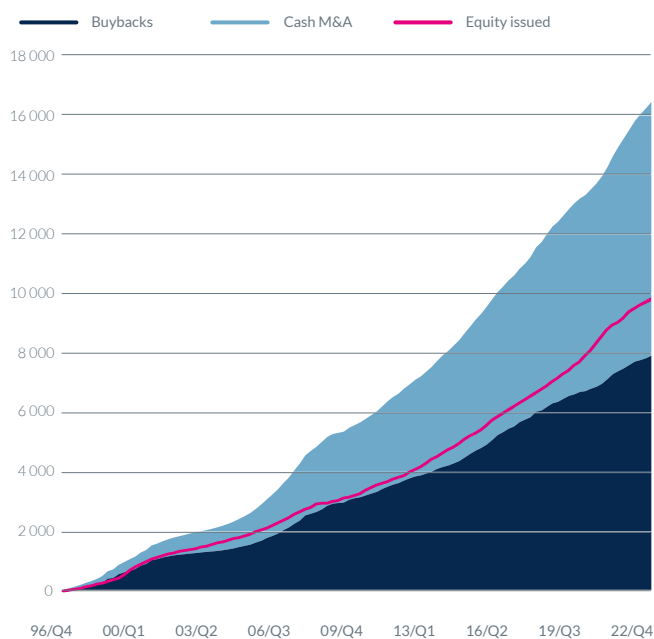
There's no real inflationary impulse from commodity prices, however. In particular, oil prices have slumped and the price of natural gas has fallen sharply. Apparently, the market no longer worries about the European energy supply, although the Russian military aggression keeps adding to geopolitical tensions and uncertainty.

Many observers worry about the high levels of government debt, particularly in the US, where a divided Congress keeps making last-minute deals to suspend or adjust the debt ceiling. Let it be noted, though, that a large share of this debt – about 44 per cent – is owned by various government agencies including the Federal Reserve. Foreign investors now make up 23 per cent, with a steadily diminishing share for the two largest creditor nations, China and Japan.

I'm not that anxious to see more rate cuts. Our fixed-income funds are doing just fine with higher interest rates, having predominantly floating-rate notes, and our portfolios of strong, low-leverage companies will strengthen their competitive positions.

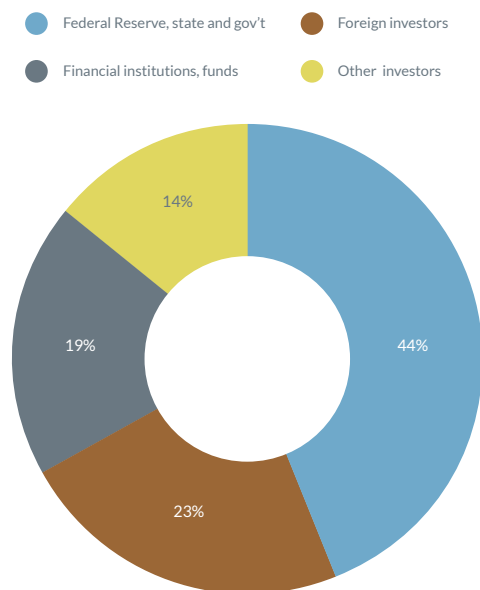


A steady supply of liquidity



US non-financial corporations, accumulated figures in billions of dollars. Source: FRED

Who owns the US debt?



Estimated ownership of US treasury securities. Source: US Treasury Bulletin

I'm rather curious to see **why** rates will be cut. If they come about as a response to falling inflation, that's good news. If, to some extent, they reflect a surprisingly weak economy or recession fears, the financial markets are likely to be less exuberant.

Presently, growth is sustained by expansionary fiscal policies and very low saving rates. In the absence of one or both, growth will be hard to sustain in the short run. On the other

hand, this would make interest rate cuts more likely – in a nice reminder that financial-market events are seldom only positive or only negative. Twisting an old proverb, one company's bad news may be another company's good news.

You can't bet on positioning yourself on the side of good news. That's speculation. You can, however, make sure your portfolio is equipped to better withstand different kinds of news.

2023 in a nutshell

OSEBX	9.9%
S&P 500 return	26.3%
MSCI World net (USD)	23.7%
3-month NIBOR	from 3.26% to 4.73%
10-year Norwegian Treasury	from 3.17% to 3.25%
10-year Swedish Treasury	from 2.39% to 2.03%
10-year US Treasury	from 3.88% to 3.88%
Brent Blend	from USD 85.91 to USD 77.04
USD/NOK	from 9.85 to 10.16
EUR/NOK	from 10.51 to 11.22
USD/SEK	from 10.42 to 10.08
GDP growth, global	3.1%
GDP growth, Norway	0.5%
GDP growth, Sweden	-0.2%
GDP growth, Mainland Norway	0.7%

Sources: Oslo Børs, S&P Dow Jones Indices, MSCI, Norges Bank, FactSet, IMF, SSB, SCB, Riksbanken, Pareto.