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# THE Q4 2023 WISDOMTREE ECONOMIC & MARKET OUTLOOK IN 10 CHARTS OR LESS

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10/20/2023

*“I just dropped in to see what condition my condition was in.”  
(Kenny Rogers & The First Edition, 1967)*

The first three quarters of 2023 were marked by a handful of factors and issues, among them: (1) the continued performance dominance of large-cap “mega-cap tech” stocks (and the corresponding continued underperformance of small-cap stocks); (2) a U.S. economy that continues to be more resilient than many expected; (3) a [Fed](#) that seems to be at or near the end of its rate hike cycle; (4) the ongoing Russia/Ukraine war; (5) simmering tensions between the U.S. and China; and now, of course, (6) the outbreak of war between Israel and the Iran-sponsored Palestinian Hamas.

As always, when reviewing the current state of the global economy and investment markets, we recommend focusing on market signals and weeding out market *noise*. We believe the five primary economic and market signals that provide perspective on where we go from here are GDP [growth](#), earnings, [interest rates](#), [inflation](#) and [central bank policy](#).

This is not to dismiss geopolitical issues or political dysfunction in Washington, DC. But these are what we refer to as “known unknowns”—we are aware of them but have no way to forecast how they will turn out or what effects they will have (or not) on the economy or investment markets.

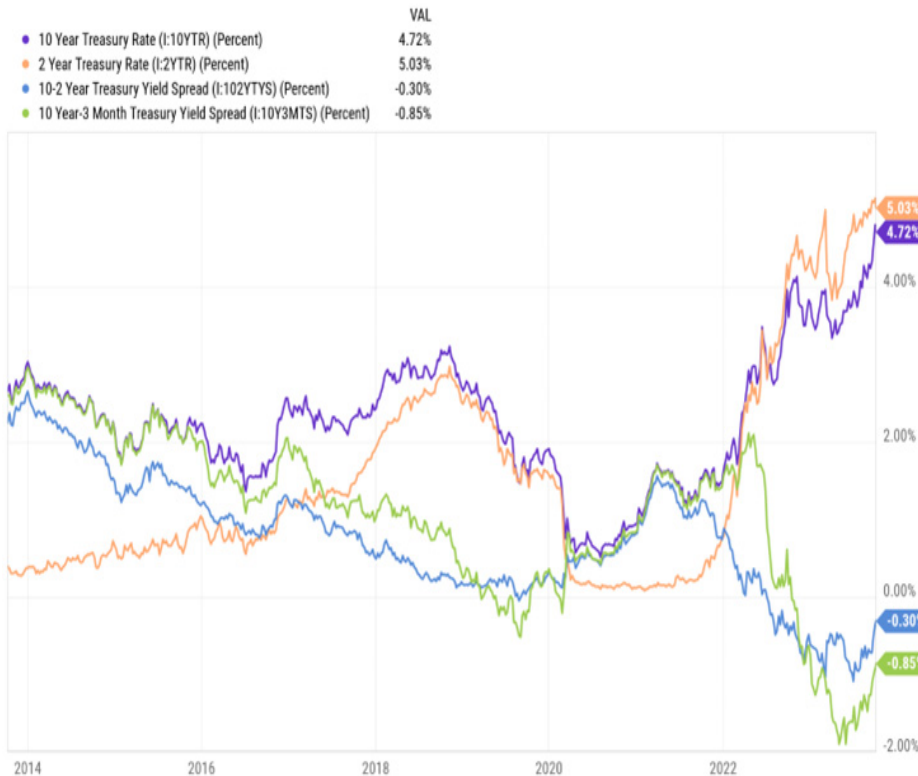
*Spoiler alert:* We now believe that any U.S. [recession](#) will be pushed out until later in 2024, maybe not even until 2025. The proverbial economic “soft landing” is no longer dismissed by analysts.

So, let’s dive in.

## GDP, Inflation and Central Bank Policy

Let’s start with a look at the [yield curve](#) (i.e., interest rates), specifically two closely watched “spreads”: the 2-Year/10-Year (2s/10s) and the 3-Month/10-Year (3m/10s). While the yield curve remains inverted (historically, a leading indicator of recession), the recent steepening of the yield curve (specifically, the dramatic rise in longer-term rates) suggests that the Treasury and bond markets are “normalizing.” “Higher for longer” remains our mantra.

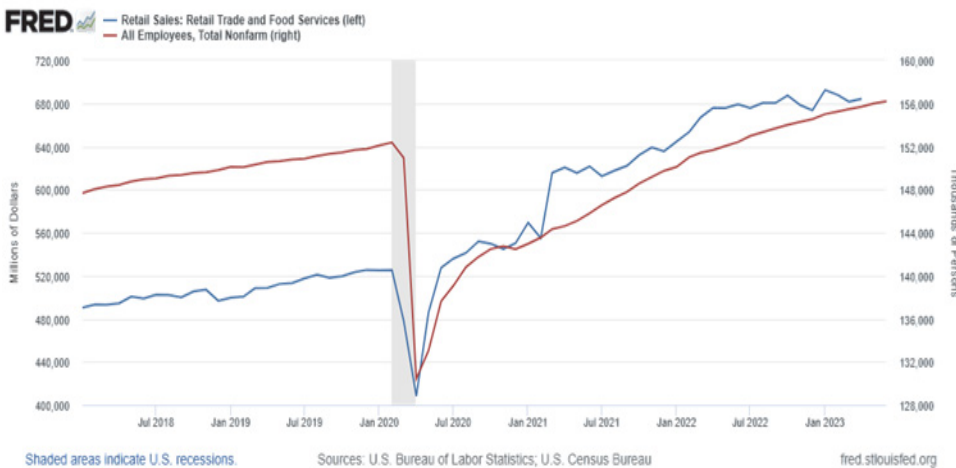
Investors who have only been in the markets since the [great financial crisis](#) in 2008 might interpret the recent increase in rates as a “crisis” when, in reality, we are simply moving “back to the future” to where the Treasury curve is increasingly driven by investors (as it should be) versus Federal Reserve intervention.



Oct 09 2023, 3:22PM EDT. Powered by YCHARTS

Source: YCharts, 10-year data through 10/6/23. You cannot Invest in an Index, and past performance is no guarantee of future results.

We see that the 2s/10s has been inverted since roughly July 2022, while the 3m/10s in October 2022. The recent trend toward “normalization,” however, suggests that the market is responding to the Fed reducing its market interventions and to ongoing economic resiliency, especially given the continued strength of labor and retail sales indicators.



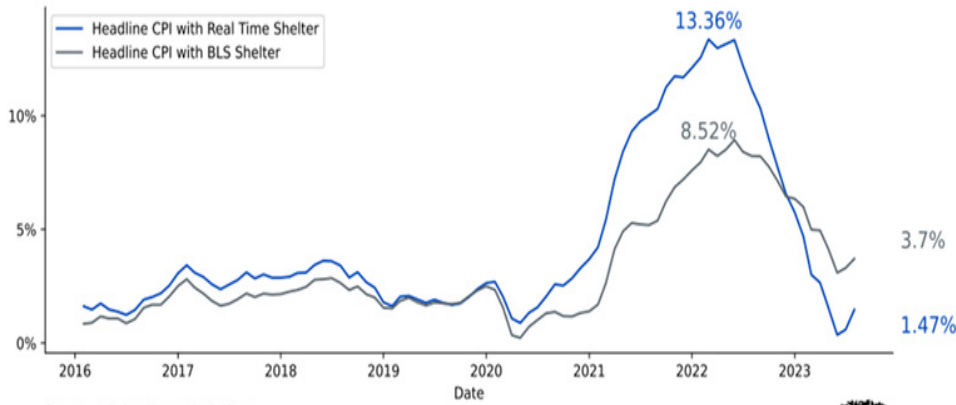
Source: St. Louis FRED. Retail sales data through August 2023; Nonfarm payroll data through September 2023. Past performance is subject to revision and does not guarantee future results.

While some argue that inflation remains a concern in 2023, it certainly is trending in the right direction. We believe the Fed is at or near the end of its [rate hike](#) cycle, and it continues to reduce its [balance sheet](#). The market itself is not pricing in any rate *cuts* until June of next year—quite a reversal from the beginning of the year when

cuts were anticipated as early as this past June.

We note that the headline [CPI](#) number is significantly impacted by housing and shelter data, which are subject to around a six-month reporting lag. CPI would look much lower if current or contemporaneous shelter data were used.

**Trailing 12M Headline Inflation: with Alternative Shelter Metrics**

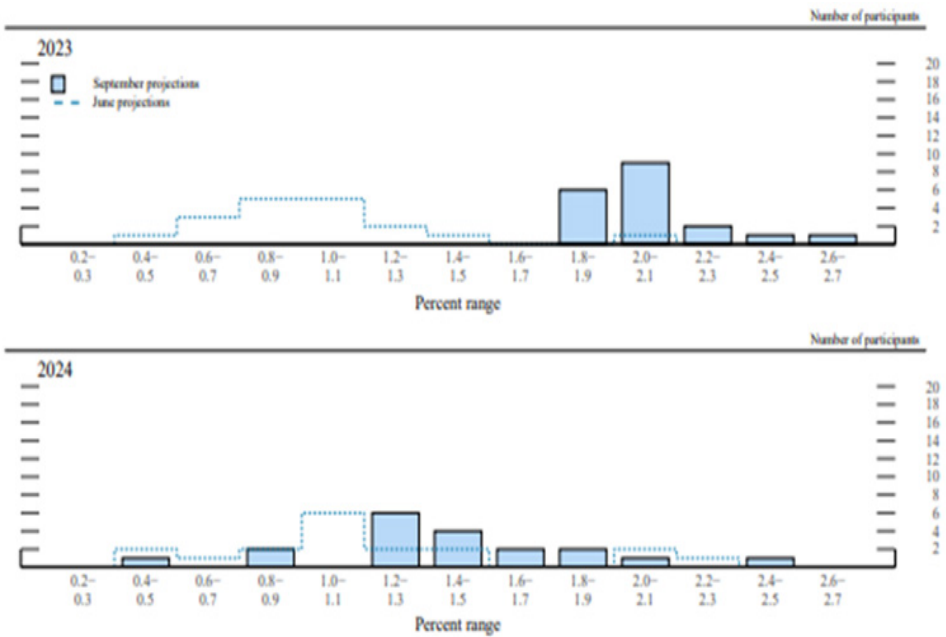


Source: WisdomTree calculations. CPI data from BLS. Alternate measures of shelter include replacing Primary Rent with Zillow Rental Index and BLS Owners' Equivalent Rent with Case Shiller Housing Data



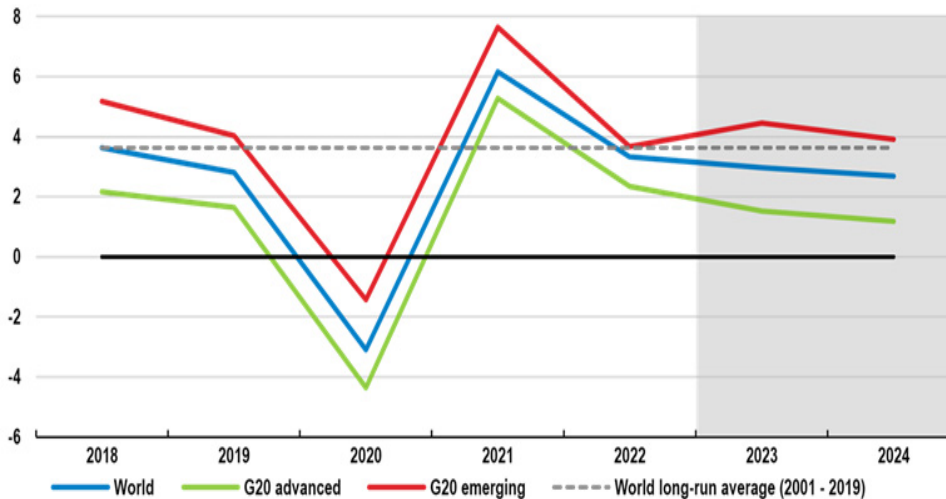
Source: WisdomTree, through 9/30/23.

Estimates for annual GDP growth in 2023 and 2024 are muted but positive.



Source: The Federal Open Market Committee (FOMC) "Summary of Economic Projections," as of 9/20/23. These are projected results and are subject to revision. Actual results may differ.

Estimates for economic growth outside the U.S. are also muted but positive.



Source: The OECD Economic Outlook Interim Report, as of September 2023. There is no guarantee that any projection, forecast or opinion will be realized. Actual results may vary.

*Translation: while economic growth may be slowing, it is proving to be more resilient than expected. Here in the U.S., there remains positive economic news, especially in consumption and labor, but some indicators—especially manufacturing—are in “contractionary” mode.*

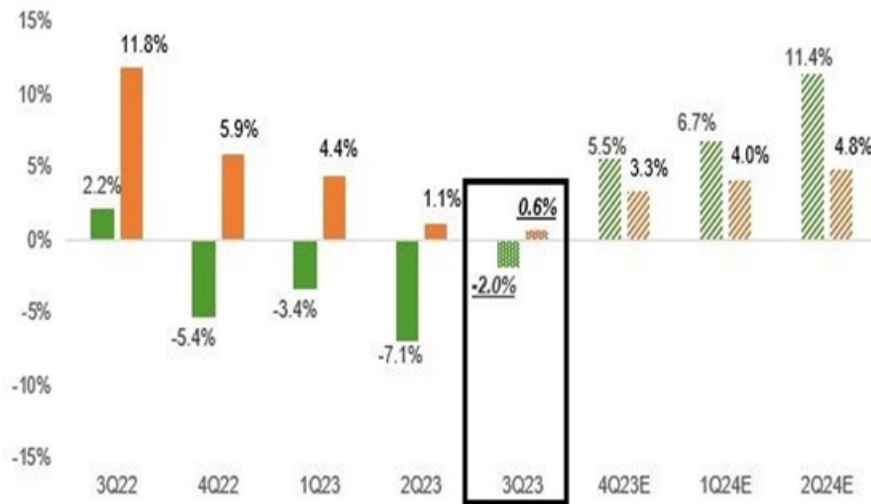
*While the Fed will be highly “data dependent” as we move through 2023, we believe we are at or close to the end of the rate hike cycle, with perhaps one more hike in 2023. The market currently is not pricing in any rate cuts until well into next year.*

#### Earnings and Valuations

The Q3 earnings season is just getting started. The consensus is that 2023 will witness a small decline in corporate earnings but then improve again as we move into Q4 and 2024. Wage increases and declining productivity are putting downward pressure on margins, but this is somewhat mitigated by the continued strength of the labor markets and the labor participation rate.

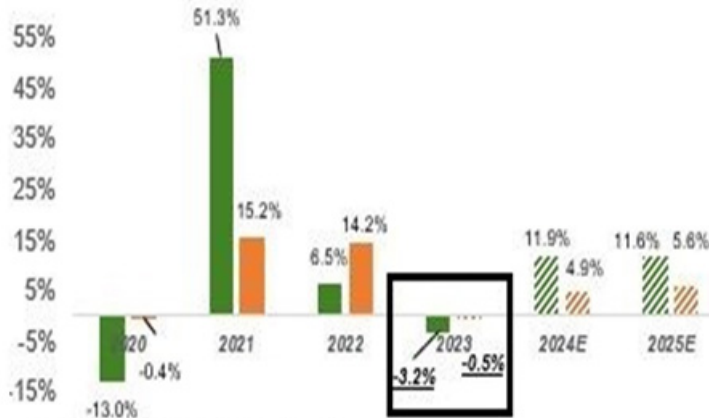
One question is whether the “[AI](#)-themed” stocks that have driven so much of market performance YTD will be able to continue to generate sufficient earnings to maintain their current elevated [valuations](#). In a recent blog post titled “[Growth Stocks Are Less Expensive than Traditional Measures Imply](#),” however, we suggest that valuations may not be as high as suggested if “intangible adjusted” valuation metrics are used.

Quarterly Earnings & Revenue Growth (YoY)



Source: Zacks Investment Research, Inc.

Annual Earnings & Revenue Growth Rate - S&P 500



Source: Zacks Investment Research, Inc.

Source for both charts: Zacks earnings estimates, as of 10/4/23. The green bars represent revenue, and the orange bars represent earnings. Hashed boxes are future estimates and are subject to change. Past performance does not guarantee future results, and actual results may vary.

Outside the U.S., fundamental and dividend-driven investors may find relative valuations to be attractive. That said, we are less optimistic about economic growth outside the U.S., especially in Europe and China, and the dollar has been on a strong rally for several months.

For these reasons, we recently reduced our exposures to [EAFE](#) and [EM](#) in favor of going over-weight in the U.S. relative to the [MSCI ACWI Index](#).



*Translation: Global equity markets remain relatively “complacent,” though they do react to changes in interest rates (and have fallen with the recent rise in rates). Ex-the mega-cap tech “AI” stocks, market valuations are in line with historical averages, with perhaps relative [value](#) available outside the U.S. For U.S. investors, non-U.S. markets remain sensitive to slower economic growth rates and an upward-trending dollar.*

*We saw a strong factor rotation toward large-cap growth and mega-tech stocks through the first three quarters of 2023. Those factors “rolled over” slightly in Q3 as interest rates rose but remain the dominant ones in overall market performance.*

*Small-cap and value stocks continue to represent a relative value opportunity going forward, though small caps are also more sensitive to interest rates and to the financial and energy sectors, which have performed relatively poorly so far this year. Q3 showed signs, however, of a potential “re-rotation” back toward value stocks in both large and small caps.*

*We believe “quality” (i.e., companies with strong balance sheets, earnings and cash flows) will become increasingly important as margins and earnings get squeezed. Firms that can maintain their pricing power and dividends should more consistently perform.*

#### **Interest Rates and Spreads**

The yield curve remains an item of intense focus these days. We discussed the level and shape of the curve above, but what about [credit spreads](#)?

Credit spreads remain in line with historical levels (despite a recent uptick in high-yield spreads). This, combined with positive real rates across the maturity spectrum, translates into “there is income back in fixed income.”

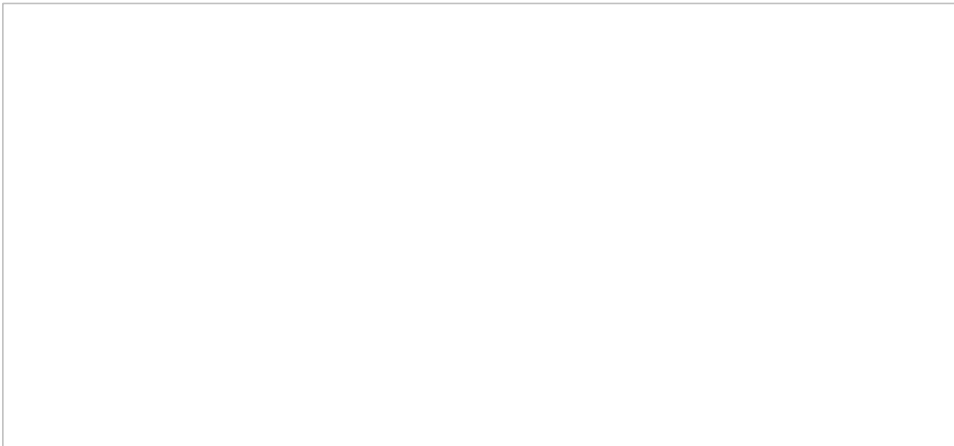
Corporate balance sheets and debt structures are in decent shape, so coupons should be safe. We increased the [duration](#) of our strategic fixed income model several months ago but remain short duration relative to the [Bloomberg Aggregate Index](#), as well as overweight in quality credit.

We believe that, given their current yields, high-yield bonds offer an adequate “buffer” to adverse movements in either rates or spreads, and given the shape of the yield curve, we still like [floating rate Treasuries](#).

Despite our favorable view of high yield, we did recently make the decision within our Model Portfolios to reduce our high-yield over-weight positions and reallocate into [mortgage-backed securities](#).



Investors continue not to be rewarded for taking on duration risk. This chart illustrates why we still favor floating rate Treasuries and U.S. corporate high-yield.



#### Summary

When focusing on what we believe are the primary economic and market signals, the *“condition our condition is in”* is positive, with some uncertainties—specifically, a still publicly [hawkish](#) Fed and heightened geopolitical tensions.

Economic growth is proving to be resilient, and recessionary fears have been pushed back until well into 2024. Earnings are expected to decline in Q3 but then improve going forward.

To summarize our primary investment themes and views for the remainder of 2023 and into

2024:

- There is income back in fixed income. We believe there continues to be relative value in high yield, and we continue to like U.S. floating rate Treasuries.
- Despite market performances YTD, we maintain our conviction in value, small-cap and dividend stocks.
- Quality continues to be the most consistently performing risk factor (rarely the best or the worst) and remains the “anchor” factor tilt in our Model Portfolios.
- U.S. small-cap stocks continue to present attractive valuation plays.
- Non-U.S. markets present interesting valuation and dividend opportunities, but we are concerned about economic growth and the direction of the dollar.
- Active management and intelligent risk factor tilts should be rewarded versus passive management (i.e., cap-weighted “beta”).
- Real assets (e.g., commodities and MLPs) and alternative strategies (e.g., managed futures and option-based) continue to present interesting diversifying opportunities.

As generally strategic investors, we continue to recommend focusing on a longer-term time horizon and the construction of “all-weather” portfolios, diversified at both the asset class and risk factor levels.

For standardized performance and the most recent month-end performance click [here](#) NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

#### Related Blogs

- + [The WisdomTree Q1 2023 Economic and Market Outlook in 10 Charts or Less](#)
- + [The Q2 2023 WisdomTree Economic Market Outlook in 10 Charts or Less](#)
- + [The Q3 2023 WisdomTree Economic Market Outlook in 10 Charts or Less](#)

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## DEFINITIONS

**Federal Reserve**: The Federal Reserve System is the central banking system of the United States.

**Growth**: Characterized by higher price levels relative to fundamentals, such as dividends or earnings. Price levels are higher because investors are willing to pay more due to their expectations of future improvements in these fundamentals.

**Interest rates**: The rate at which interest is paid by a borrower for the use of money.

**Inflation**: Characterized by rising price levels.

**Central bank**: Refers to the the monetary authority of any country.

**Recession**: two consecutive quarters of negative GDP growth, characterized generally by a slowing economy and higher unemployment.

**Curve**: Refers to the yield curve. Positioning on the yield curve is important to investors, especially during non-parallel shifts.

**The Global Financial Crisis**: Refers to the period of extreme stress in global financial markets and banking systems between mid 2007 and early 2009.

**Rate Hike**: refers to an increase in the policy rate set by a central bank. In the U.S., this generally refers to the Federal Funds Target Rate.

**Balance sheet**: refers to the cash and cash equivalents part of the Current Assets on a firms balance sheet and cash available for purchasing new position.

**Consumer Price Index (CPI)**: A measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. The CPI is calculated by taking price changes for each item in the predetermined basket of goods and averaging them; the goods are weighted according to their importance. Changes in CPI are used to assess price changes associated with the cost of living.

**Artificial intelligence**: machine analysis and decision-making.

**Valuation**: Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

**EAFE**: Refers to the geographical area that is made up of Europe, Australasia and the Far East.

**Emerging market**: Characterized by greater market access and less potential for operational risks when compared to frontier markets, which leads to a larger base of potentially eligible investors.

**MSCI ACWI Index**: A free-float adjusted market capitalization-weighted index that is designed to measure the equity market performance of developed and emerging markets.

**Value**: Characterized by lower price levels relative to fundamentals, such as earnings or dividends. Prices are lower because investors are less certain of the performance of these fundamentals in the future. This term is also related to the Value Factor, which associates these stock characteristics with excess returns vs the market over time.

**Spread**: Typically refers to a difference between a measure of yield for one asset class and a measure of yield for either a different subset of that asset class or a different asset class entirely.

**Duration**: A measure of a bond's sensitivity to changes in interest rates. The weighted average accounts for the various durations of the bonds purchased as well as the proportion of the total government bond portfolio that they make up.

**Bloomberg Aggregate Bond Index**: The Bloomberg Aggregate Bond Index or "the Agg" is a broad-based fixed-income index used by bond traders and the managers of mutual funds and exchange-traded funds (ETFs) as a benchmark to measure their relative performance.

**Floating Rate Treasury Note**: a debt instrument issued by the U.S. government whose coupon payments are linked to the 13-week Treasury bill auction rate.

**Mortgage-backed securities**: Fixed income securities that are composed of multiple underlying mortgages.

**Hawkish**: Description used when worries about inflation are the primary concerns in setting monetary policy decisions.