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Against the backdrop of low expectations, 2023 helped wash away the sour taste of 2022. The S&P 500® index returned more than 26 percent and all major indices posted handsome advances. Fueling the equity markets were two unrelated catalysts. Artificial intelligence emerged as a driving force, as many companies raced to incorporate this novel technology into their businesses. The second factor boosting the markets was what did not transpire—a much-anticipated recession. As we look ahead, investors are left to ponder whether the recent fertile environment will continue for equities.

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As the year began, most investors and economists believed a recession to be a foregone conclusion. Based on history, little evidence existed that the Federal Reserve could raise interest rates high enough to sufficiently control inflation without inflicting economic harm that induces a recession. The first quarter included the turbulence of the regional banking crisis whereby smaller regional banks struggled with the rapidity of interest rate increases and the resulting lending rate mismatch. Silicon Valley Bank failed, along with some less notable lenders, but the Fed acted quickly to provide near-term liquidity to stabilize smaller financial institutions. Later in the year, a second war emerged in the Middle East that threatened economic stability. Remarkably, however, oil prices weakened and closed the year at around $77 a barrel, a decline of 10 percent for the year. Despite these obstacles, a recession never materialized. Instead, economic growth was healthy, and near the end of 2023 the Federal Reserve signaled that they may be concluding their aggressive efforts to combat inflation. This enabled the S&P 500® to finish the year on a nine-week winning streak, the index's longest since January 2004.

In addition to healthy returns, the year 2023 will long be remembered as the year when the concept of artificial intelligence (AI) emerged as a paradigm-shifting force in the economy. This topic dominated both the financial and mainstream news and was a topic from Congress to corporate boardrooms. It was reminiscent of the proliferation of the world wide web in the late 1990s. While the potential impact of AI is undeniable, how to best invest in this technology is up for debate. Emerging companies who are building their businesses around AI captured their fair share of headlines. This is much like what transpired in the late 1990s with internet-centric companies like Netscape, Napster, and Pets.com. As with the internet, however, we believe the most durable and most significant beneficiaries of artificial intelligence will be those companies that effectively leverage this powerful technology within their existing businesses to fortify their market positions. The Riverbridge portfolios contain many such companies that are already beginning to incorporate AI into their existing operations.

This coming year, the market will have to grapple with a formidable force it avoided in 2023: high expectations. Investors expect the Fed to initiate up to six rate cuts in 2024 beginning as early as March. Many of the most prominent companies that disproportionately drove the markets to new heights—the so called Magnificent Seven—now sit at elevated valuation levels, which makes a repeat of 2023's stellar returns less likely. Unlike last year, investors no longer anticipate a looming recession. Should economic growth stall, corporate earnings will also likely suffer.

As our long-term clients are aware, Riverbridge does not attempt to forecast the markets over the next year as the exercise is futile. Few, if any, forecasters accurately predicted the equity markets to increase 20 percent last year. Instead, our investment team focuses on identifying and investing in companies with high degrees of recurring revenue that can grow their earnings regardless of the economic environment. Our portfolio companies tend to be less susceptible to geo-political risk or even economic risks such as fluctuating commodity prices or interest rates. While we avoid making market predictions, we are confident that our portfolio companies are well positioned to continue to build their earnings power in 2024.