Monday November 20, 2023

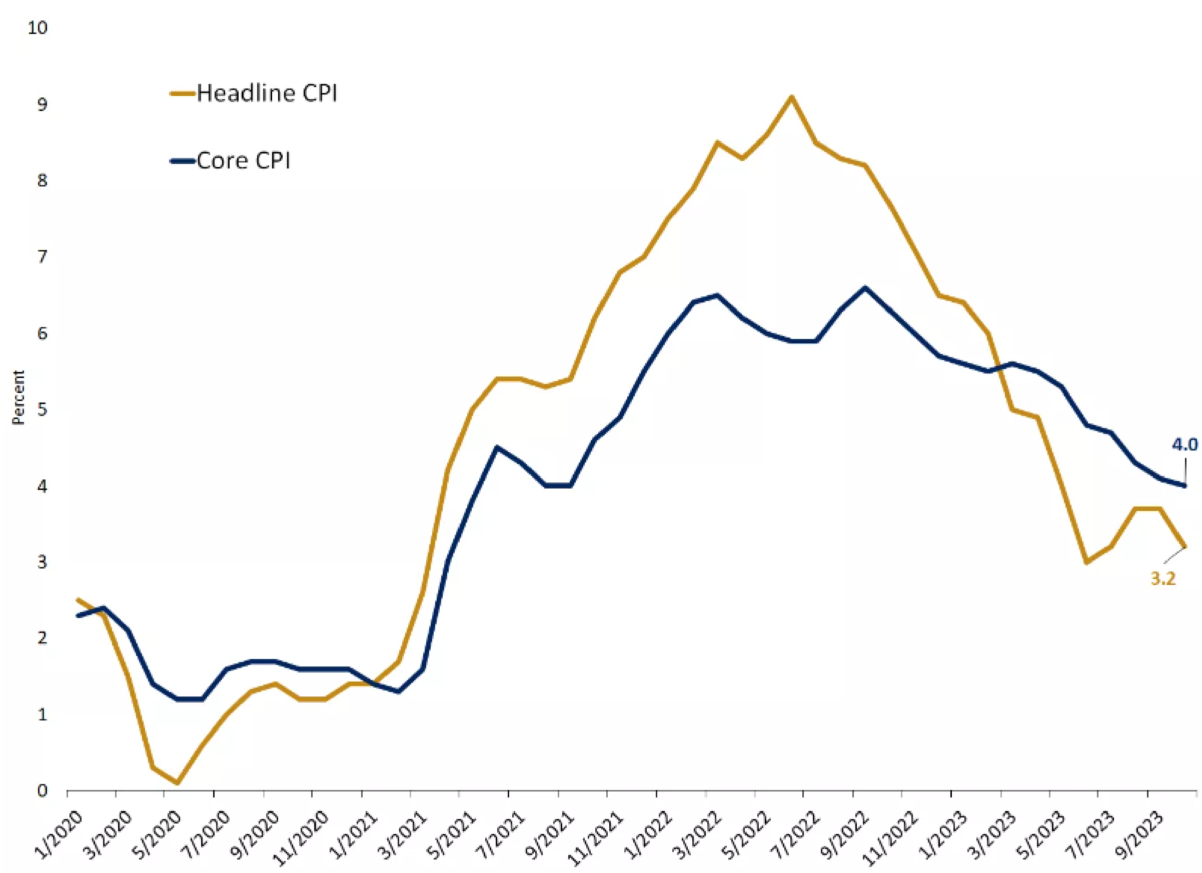
SUMMARY-

I. Cooler inflation data propels stocks higher.
II. Declining bond yields predict rate cuts in 2024.
III. Broadening markets suggest normalizing performance.
IV. End of Fed cycle could mean rebound in laggards.

Good morning:

Markets celebrated softer inflation data last week as both CPI and PPI reports for October came in at or better than expectations. Stocks rose about 2% for the week in a fairly broad based continued rebound from October's correction. Helped by a sizable drop in gasoline prices, the headline annual CPI rate dropped from 3.7 to 3.2% last month. While still above the Fed's 2% inflation target, oil's 20% decline from September's high should continue to help consumer price declines in the coming months. Barring any surprise reacceleration in prices, the current trend could keep the Fed on the sidelines, while their rhetoric continues to indicate a willingness to hike further if necessary.

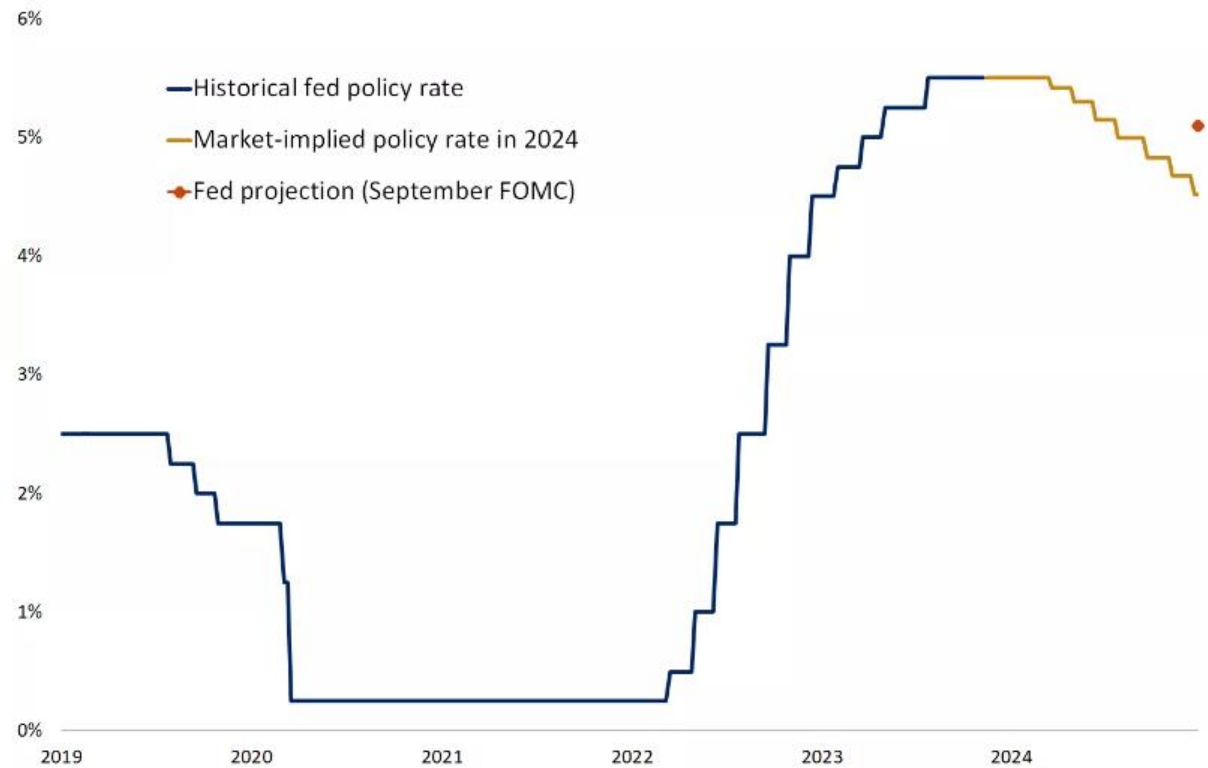
Inflation remains on a downtrend, taking some pressure off the Fed



Source: Bloomberg.

Further helping equities was the continued decline in bond yields. After nearly touching the 5% level, the critical 10-year Treasury bond declined further last week to close at 4.43%. It appears that institutional fixed income traders are beginning to price in Fed rate *cuts* in 2024 and beyond. We expect the Fed to make good on their “higher for longer” prediction while they remain on diligent watch for any signs of renewed inflation. However, if price pressures continue to moderate in 2024 as many believe, real policy rates (after adjusting for inflation) will become more restrictive, which the Fed will likely try to offset by cutting rates more than the two times it is currently projecting.

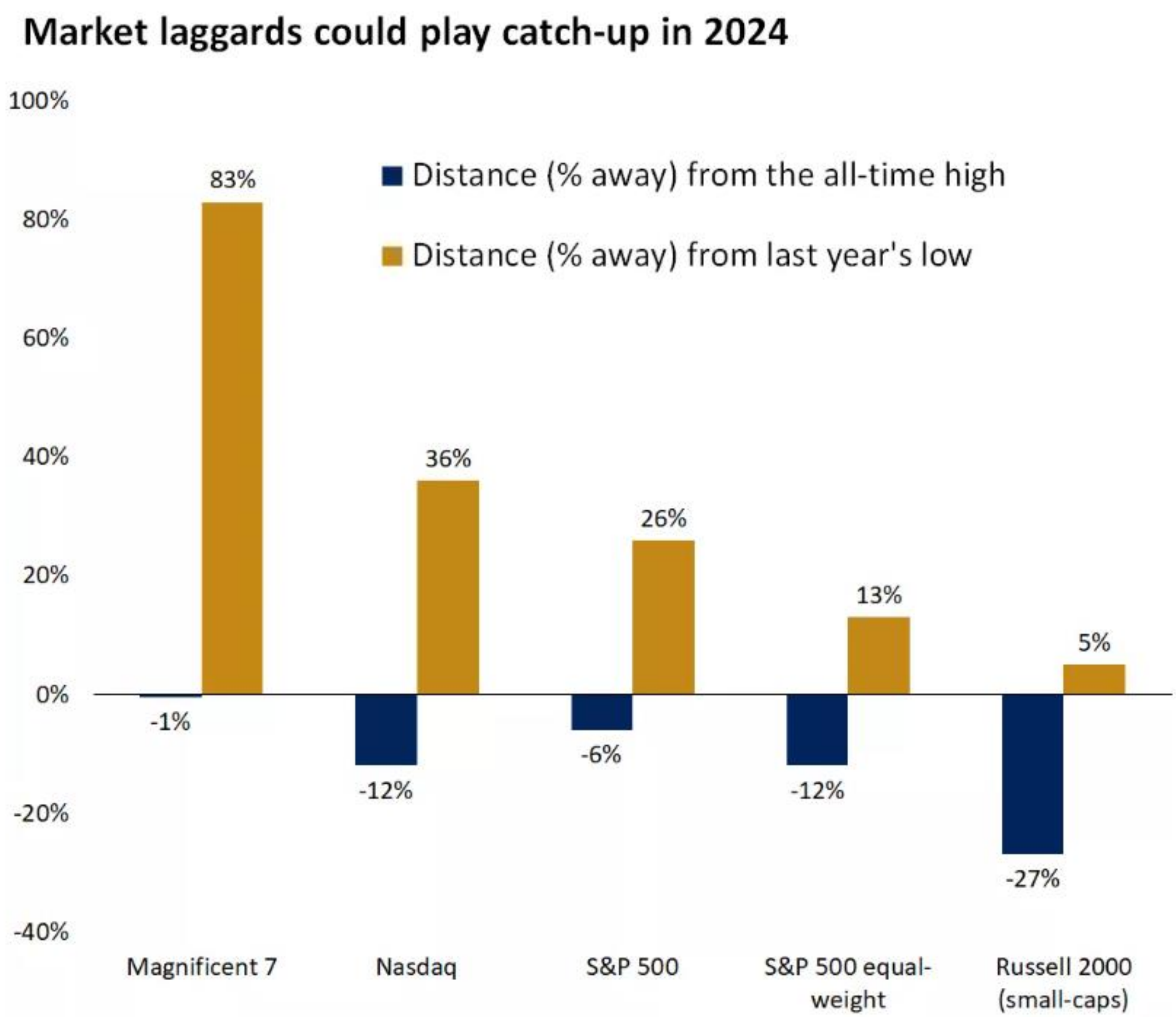
Fed will likely push back against easing, but may end up cutting rates in 2024 more than the two times they projected back in September



Source: Bloomberg, September FOMC meeting projections.

Last week's market moves again showed signs of the much anticipated broadening of sector leadership that we and others have been expecting for quite some time. Up to this point, most of the equity-market gains have been driven by a small number of stocks, the so-called "Magnificent 7" (Alphabet, Amazon, Apple, Meta Platforms, Microsoft, Nvidia, Tesla). Showcasing this point, the S&P 500 is now down only 6% from its all-time high in early 2022, while the equal-weight S&P 500, which assigns the same weight to all the stocks in the index, is down 12%. The Russell 2000, which is the proxy for small-cap stocks, is still down 27% from its highs. Last week's outperformance from small-caps and the "average" stock potentially offers some insight into what might unfold in 2024.

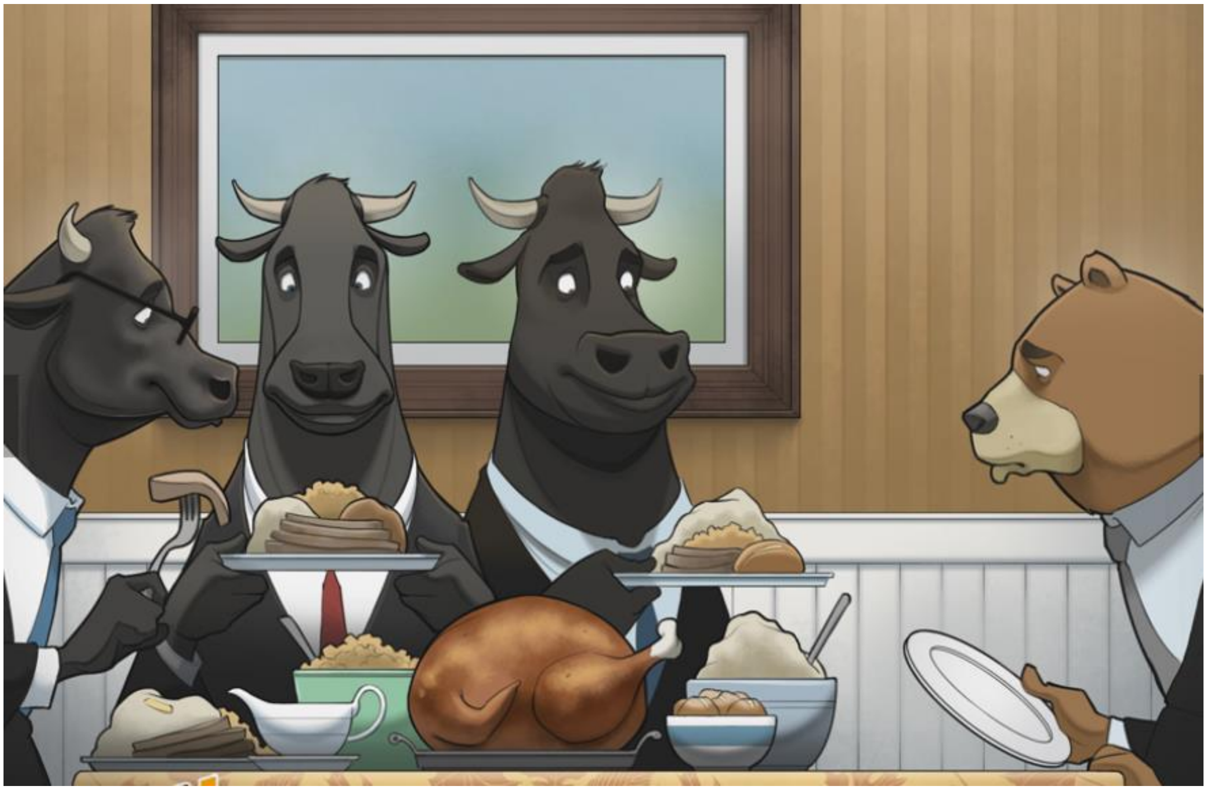
We continue to see an opportunity for laggards to catch up from here as the overhang of rising yields subsides. These include defensive dividend-paying blue-chips, small-caps, and value-style investments. A gradual cooling in the economy that allows the Fed to cut rates next year looks increasingly possible. In that scenario, the U.S. dollar could weaken, adding to international investment security returns. On the fixed-income side, a peak in rates presents an opportunity to start extending duration, with bond returns likely outperforming cash in 2024. Money market fund rates will also likely start to decline from current peak levels as the yield curve normalizes.



Source: Bloomberg

The current combined condition of the lowest CPI in two years, cooling labor markets, moderating economic growth, with a resilient consumer is clearly far better than most economists predicted at the start of this year. The majority were calling for an imminent recession, that fortunately never materialized. Among the many blessings to acknowledge this Thanksgiving, perhaps that should be included. With many of the ingredients in place for a year-end rally, particularly among stocks trading at lower relative valuations, we remain cautiously optimistic that we have seen the worst of the year's market decline and the Fed's rate hiking cycle.

Our office and the markets will be closed on Thursday, but open again until noon CT on Friday. As we start this holiday-shortened trading week, we are happy that more of the “bulls” have made their appearance this Thanksgiving after a largely bearish year for much of the market.



Have a great week and Happy Thanksgiving!

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