Monday October 30, 2023

SUMMARY-

I. Stocks hit 5-month low and enter correction territory.

II. Bond yields could be peaking as Fed likely remains on hold.

III. Resilient economy and consumer help GDP and earnings in Q3.

IV. Lower equity valuations may help stocks into year end.

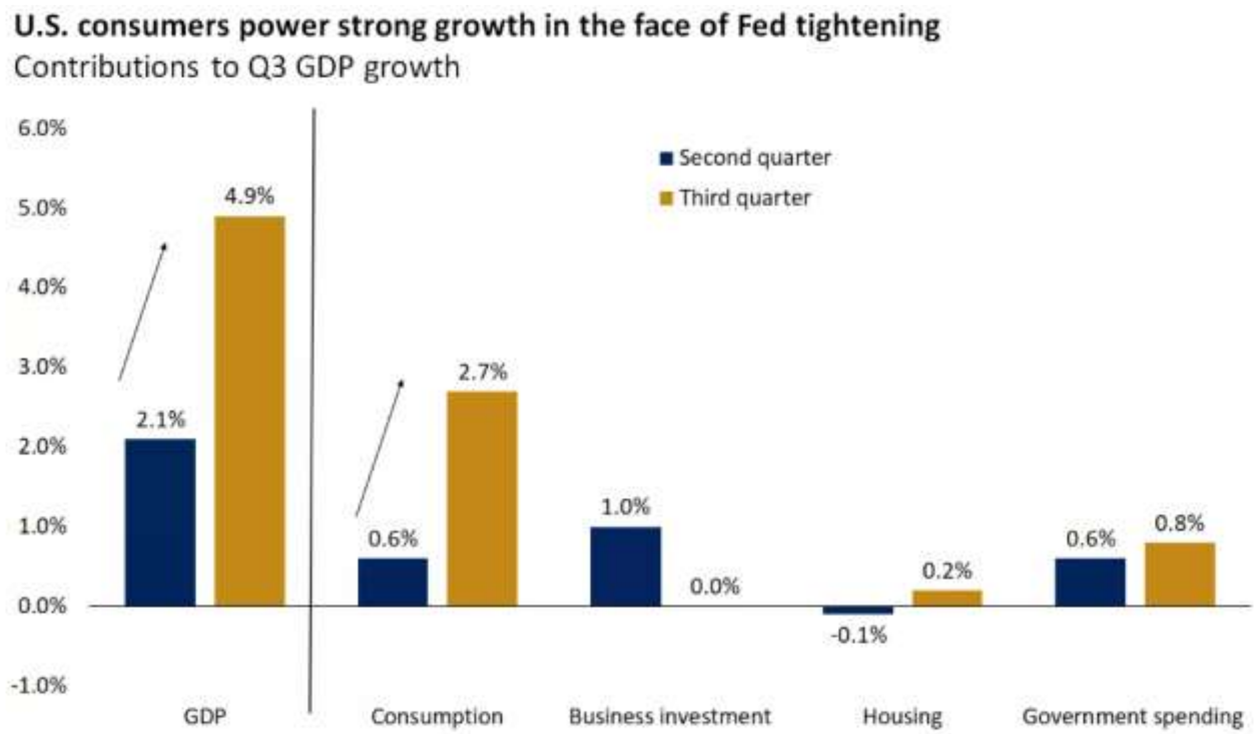
Good afternoon:

Major equity averages officially entered “correction” territory with a decline of 10% from July’s high level as stock indices declined about 2½% last week. With the 10-year Treasury yield near 5% and mixed results and guidance from several mega-cap tech companies, the path of least resistance was lower for many stocks, prompting the S&P 500 to hit its lowest level in 5 months. While the "Magnificent Seven" (Amazon, Apple, Alphabet, Meta, Microsoft, NVIDIA and Tesla) have powered the rally since last year's bear-market low, they have also been the ones to drag major indexes lower since mid-October.

Starting this week in a fairly oversold position, stocks are staging a recovery rally this morning, once again led higher by the Mag 7 names. Whether this rebound holds may be based on the bond market, further economic data, and additional earnings reports to come this week. Clearly, the economy is at a crossroads after all the external efforts to stimulate and then subdue activity since the start of the pandemic. For many of the same reasons the widely predicted recession at the start of the year has not materialized to date, there are numerous factors that may keep equities heading higher and enable any economic downturn that develops to be of the short and shallow variety.

However, the reality is the full impact of all the Fed tightening has yet to be felt. We expect further repercussions over the next year as higher borrowing costs serve to slow growth and enterprise expansion and impact consumer spending, especially at the middle and lower-income levels. Nevertheless, markets often try to “look through” difficult environments to be well positioned for the eventual economic and earnings recovery to follow. In our current climate, bullish strategists will cite the following positive factors.

Consumer spending drove GDP at a 4.9% annual pace in the third quarter, ahead of expectations and more than double the rate of Q2. While these results are not likely to be replicated in the next few quarters, it suggests that our current strong labor market will keep consumer spending at a healthy rate for a while longer.



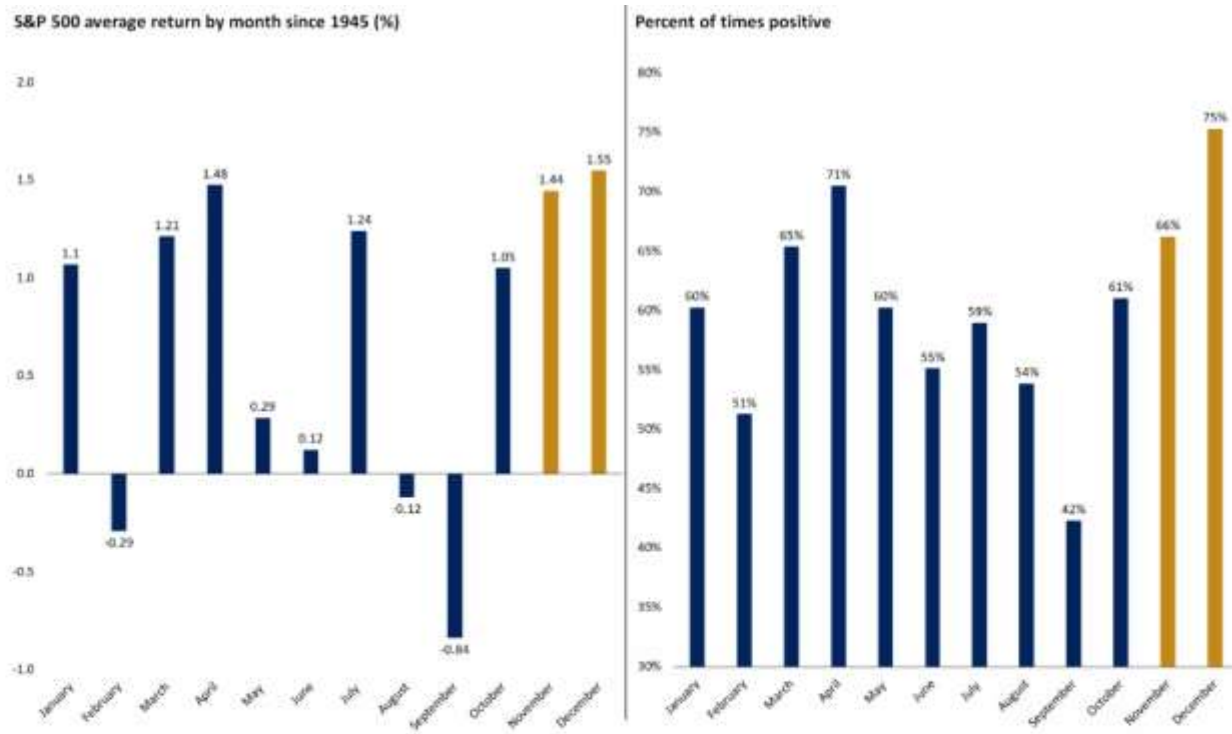
Source: FactSet

Despite the stronger than expected growth and tight labor market, inflation rates continue to decline. Currently 3.7%, down from 9.2%, the CPI is well off last year's high but still above the Fed's 2.0% target rate. However, slowing wage growth and declining housing inflation could keep the CPI heading lower in the coming months. As a result, along with the recent spike in longer-term bond yields, we believe the Fed will remain on hold again at this week's FOMC meeting. Depending on their reaction to subsequent economic data, it is possible that July's hike might have been their last of this cycle. Although they have committed to remaining "higher for longer" (even after they conclude their hikes), markets typically do well once the Fed finishes tightening in anticipation of their eventual rate cuts.

Last hike	First cut	Months from last hike to first cut	S&P 500 return	Investment grade bonds return
08/1984	10/1984	1	11%	4%
09/1987	10/1987	1	-2%	-2%
02/1989	06/1989	3	11%	7%
02/1995	07/1995	5	19%	10%
05/2000	01/2001	8	-7%	11%
06/2006	09/2007	15	25%	10%
12/2018	07/2019	7	18%	7%

Source: FactSet

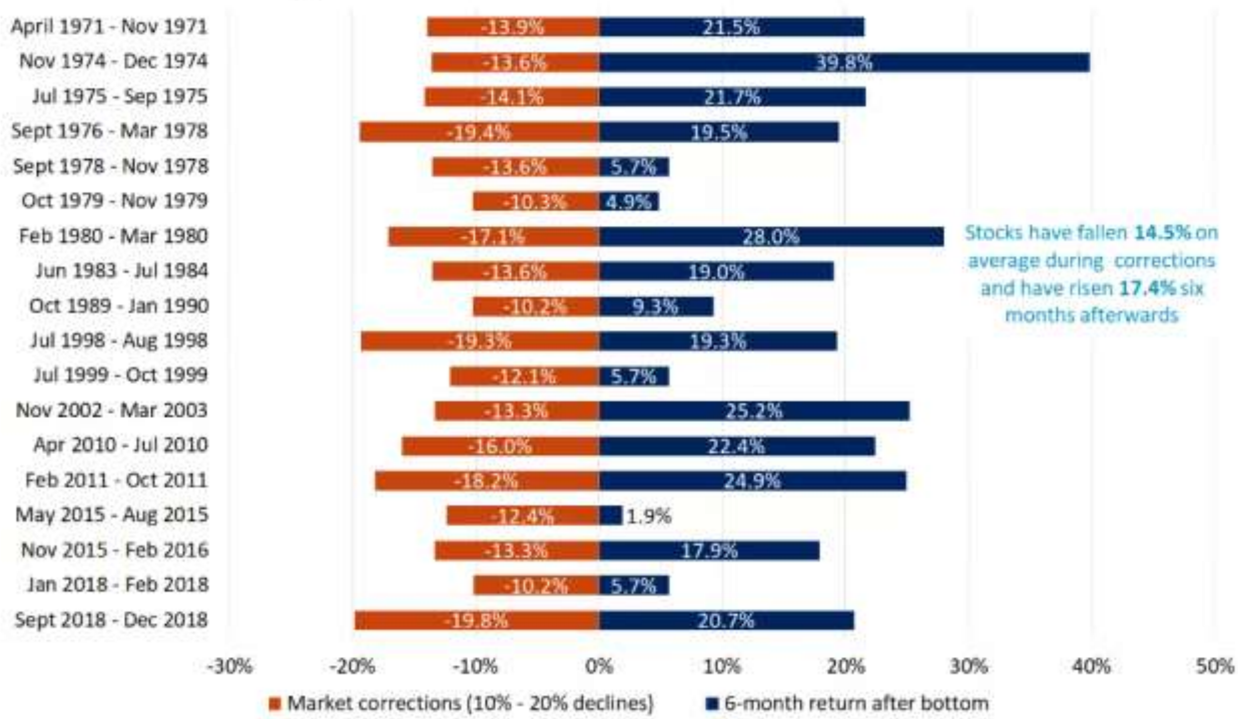
Against the backdrop of the current market correction, third quarter corporate earnings are on track to return to growth after three consecutive quarters of declining profits. Solid demand is driving sales growth and a decline in material costs is helping profitability rebound. Such rising earnings coupled with lower stock prices bodes well for better equity returns from currently lower valuation levels. As we enter the final two months of 2023, a statistically good period for stocks, lower valuations and a Fed on hold could improve investor sentiment.



Source: Morningstar

While corrections are frustrating and unpleasant, they should not be seen as unusual or something to be feared. In fact, they are quite common, occurring nearly once each year or so. All equity investors should come to expect them as a regular aspect to anticipate in their portfolios. Fortunately, markets have always fully recovered and achieved new heights for those who are patient enough to remain invested.

S&P 500 returns during and after corrections



Source: FactSet

We recognize the growing investor impatience for equities to stage a sustainable move higher and *not* just among a handful of tech stocks. With markets hating uncertainty, the current high level of macroeconomic, and to a lesser degree geopolitical uncertainty, coupled with 5%+ money market rates for sidelined cash, could require more economic clarity before additional institutional capital is committed to traditional portfolio allocations. Perhaps we are seeing the start of that today as it is often said that a healthy market is one that “climbs a wall of worry.”

Have a great week!

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The Dow Jones Industrial Average (DJIA), commonly known as "The Dow" is an index representing 30 stocks of companies maintained and reviewed by the editors of the Wall Street Journal.

The NASDAQ composite is an unmanaged index of securities traded on the NASDAQ system.

S&P 500 Index is an unmanaged, market value-weighted index of 500 stocks generally representative of the broad stock market. An investment cannot be made directly in a market index.

Market return and statistical data obtained from: https://am.jpmorgan.com/blob-gim/1383452890099/83456/weekly_market_recap.pdf?segment=AMERICAS_US_ADV&locale=en_US

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