Softening Ahoy

Weekender

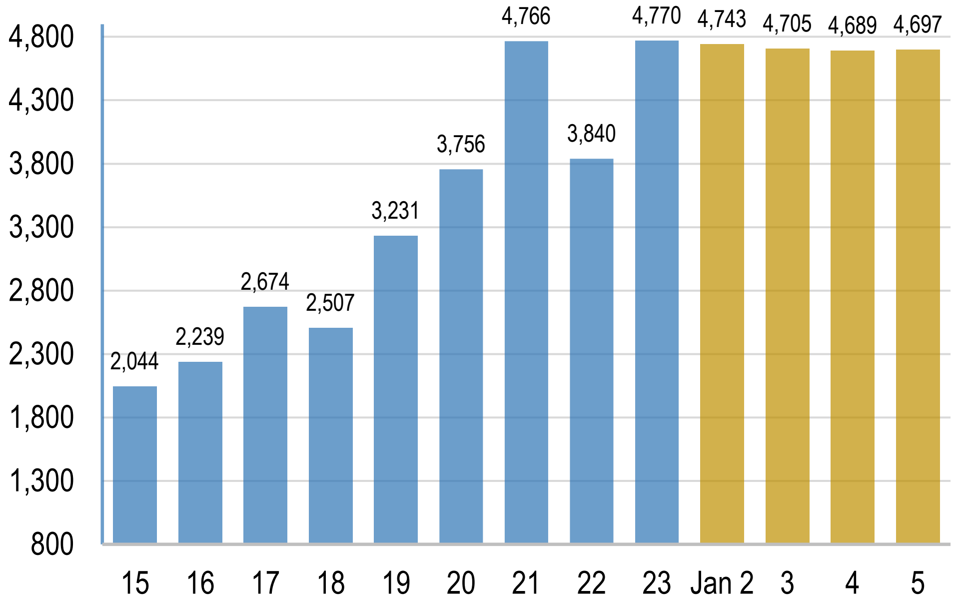
January 6, 2024

> Laughter is timeless. Imagination has no age. And dreams are forever.
>
> *Walter Elias Disney*

Good morning and welcome to the *Weekender* for Saturday, January 6, 2024. Happy New Year. As measured by the S&P 500, equity markets were lower by -1.5%. The fact that they ended lower is a notable reversal from the last ten weeks. Agita from the feeding frenzy of the last quarter of 2023 is a reasonable explanation for the drop.

S&P 500 Index Levels

(Source: Bloomberg)



Last week produced an absolute treasure trove of economic data. In the main, the data suggested the economy is approaching a soft landing. Soft landings are rare only because they never happen. But, as we have said for the last two years, this time is different. Business cycles typically go through a series of stages, moving from boom (expansion) to bust (recession). In almost all past cycles, the labor market eventually breaks, leading to increased unemployment, gut-wrenching realignments, and an eventual bottoming. A soft landing comes without the gut-wrenching part. Instead, a boom cycle slows to a new normal of slow and steady growth with moderate inflation and fully employed labor markets.

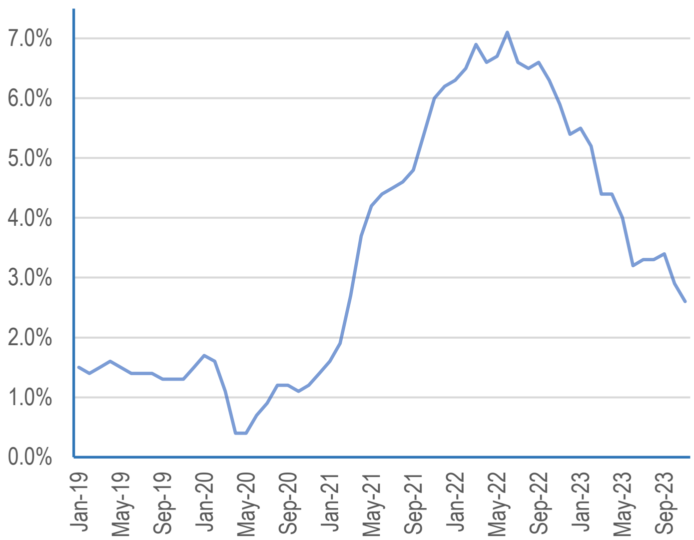
We expect a soft-landing. A more valuable question is, “where are we landing?” not how.

A year ago, inflation descended from its 2021 high toward the Fed’s target of 2.0%. Using the Federal Reserve’s preferred measure, inflation is currently at 2.6%, a shallow breath from its target. We expect that as consumer demand moderates and product inventory normalizes, inflation will continue to fall, perhaps below the Fed’s target for a moment. Target inflation will permit the Federal Reserve to move off its restrictive stance and begin poking around for an average interest rate that is moderately accommodative without stoking inflation, a challenging prospect.

PCE Inflation Year-over-Year

January 2019 - November 2023

(Source: Bloomberg)



Among many things we learned last year, most of which will be highlighted in next week’s *House View* summary, the most important is the need to be humble in the face of things we try to predict but do not thoroughly understand, like financial markets and economies. As far as the *Weekender* is concerned, we have been mostly accurate over the last year. For that, we are grateful, and hopefully, our clients have been able to take advantage. However, the year ahead is just as fraught with uncertainty as the one we leave behind. We will try to dig deep, understand the forces bearing down on the world, and lay out a path forward.

In this *Weekender,* we will provide a summary update on last week’s market-relevant data. Please be sure to consult a financial professional before making financial decisions.

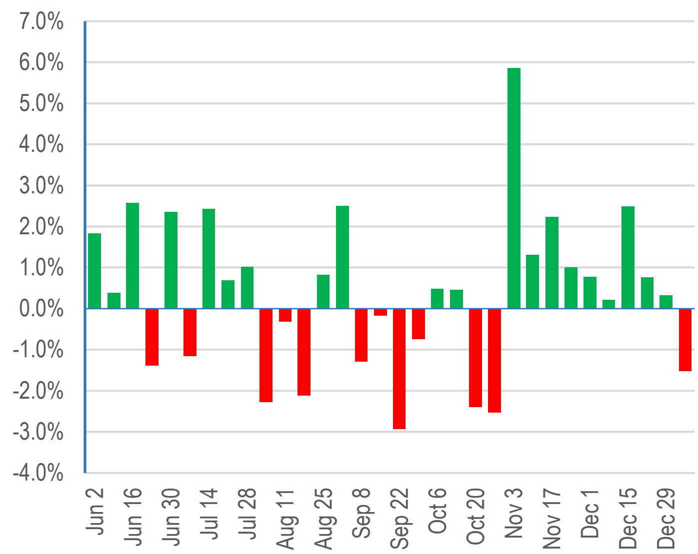
Market Update

Last week the S&P 500 fell for the first time in ten weeks, the longest win streak in approximately two decades. There is little grist from the week’s market action that can serve as a read-through for the rest of the year, but one lesson that seems to be relearned regularly suggests that all market players should be careful of overconfidence and complacency. Such a warning is remarkably prescient for this year, which we expect to be the period over which global economies and markets will begin adjusting to their new normal. A normal that is likely to set a starting line for a new cycle.

Weekly Returns

January 2, 2023 - January 5, 2024

(Source: Bloomberg)

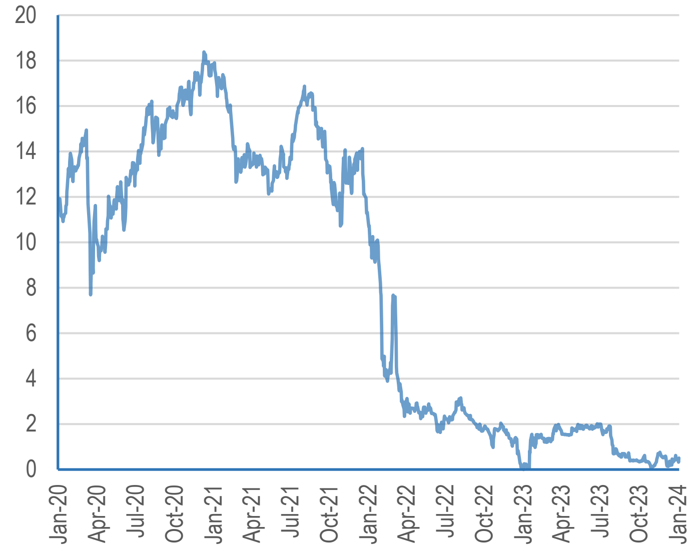


Yields on benchmark US government 10-year bonds have been falling since their October 19, 2023 peak until this week when they pushed back above 4.0% after the December jobs data suggested the Fed would not need to rush lower rates to support a slowing economy. That said, some cracks in the labor market are beginning to appear which we believe will begin softening demand for both products and services broadly. Labor participation is falling, more temporary workers are having difficulty finding work, more people are taking part-time employment for economic reasons, and there is a broad decline in the number of hours worked. None of these cracks will likely lead to an imminent decline in the labor market, but they are a helpful talisman warranting caution as we look for a new normal.

US Government 10-Year Bond Yield
January 1, 2019 - January 5, 2024
(Source: Bloomberg)

Perhaps the greatest surprise of the last year for economists is how the US economy was able to continue its growth in the face of extremely restrictive interest rates. This surprise poses several questions. Most interesting among them is whether the extremely low interest rates of the post-Credit Crisis era were essential at all or were they just political folly. Folly or not, European economies are having a more difficult time adjusting to higher rates. Going into the bowels of the pandemic, negative interest rates were standard on the continent, providing accessible capital for investment. Now, they are all but gone. A return to normal interest rates higher than inflation will likely jar economic performance and profit growth.

Negative Interest Debt (US$ Trillions)
January 1, 2020 - January 5, 2024
(Source: Bloomberg)



We believe the "everything rally" in the final quarter of 2023 has run out of steam. Last week all major asset classes fell. We believe this represents a change in investor sentiment and perspective. Before New Year fireworks were launched, investors were sure the Federal Reserve would begin lowering rates by March. After only a week of sober reflection, the probability of such a move fell to seventy percent. It's likely to continue to fall in the weeks ahead. We anticipate that the fall in rates will be slower and more incremental than markets are pricing.

Market sentiment is also having a bit of a hangover. Key market leaders in the Magnificent Seven, the primary driver of markets over the course of last year, are now wading through analyst downgrades, potential government anti-trust action, and consumer and investor exhaustion and skepticism. We believe the extreme manifestation of animal spirits characteristic of 2023's market actions is now going to settle down into a more discerning cadence based on data. Old concerns, put on the back burner in the face of lowering interest rates going into the end of last year, seemed to reemerge as investors left their laced egg nog for less festive early morning stimulants.

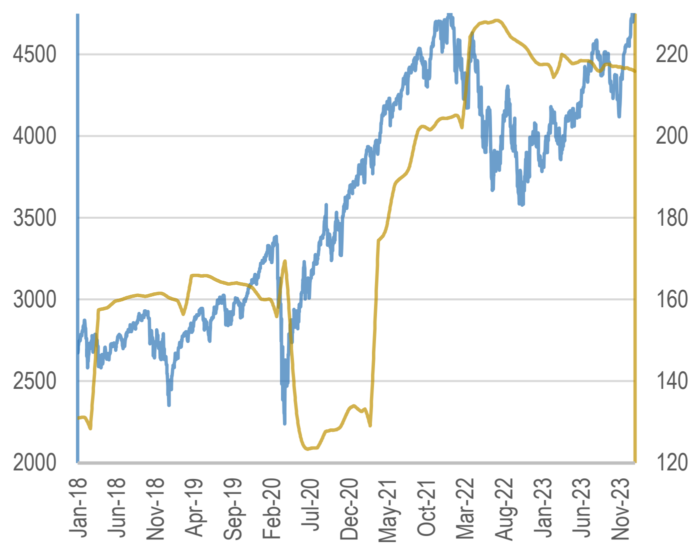
Path of Profits

One of the most exciting investing phenomena in the first week of January is the flood of New Year market expectations published by investment bank strategists and economists. On average, earnings for the S&P 500 are expected to grow by 11.0%, driven mainly by healthcare, industrials, technology, and communications. Earnings growth at 11.0% is respectable but not extraordinary. We believe these expectations are achievable as long as the US consumer remains employed, real payrolls continue to rise, and inflation and interest rates stay on their moderating path.

However, we believe earnings gains will be asymmetric. Many companies that benefitted from the largess of pandemic-related stimulus have not reset their expectations for an environment without free money. The graph below shows the influence the pandemic exerted on profits for the S&P 500. We expect a general reversion to the path of earnings growth that existed prior to the pandemic. As this reversion begins to take place in 2024, we believe investors that can discern the earnings power of a company will be able to outperform broader indices.

S&P 500 (LH) and EPS (RH)

January 1, 2018 - January 5, 2024
(Source: Bloomberg)

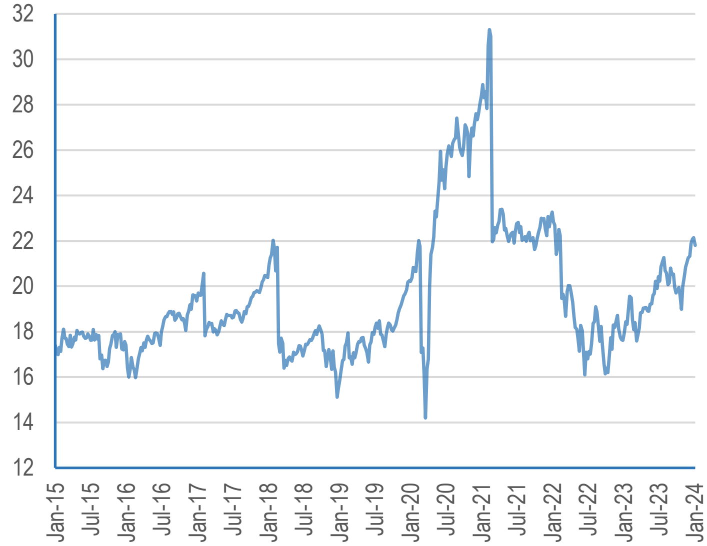


Equity Valuations

In terms of valuation, equity markets are expensive but not exceptionally so. The S&P 500 currently trades at 21.8 times 2024's earnings. Outside of the broader index, there is a degree of valuation asymmetry that is very unusual. We believe this presents an opportunity. Highly overvalued technology players will yield market leadership to undervalued index members.

S&P 500 PE Ratio

January 2, 2015 - January 5, 2024
(Source: Bloomberg)



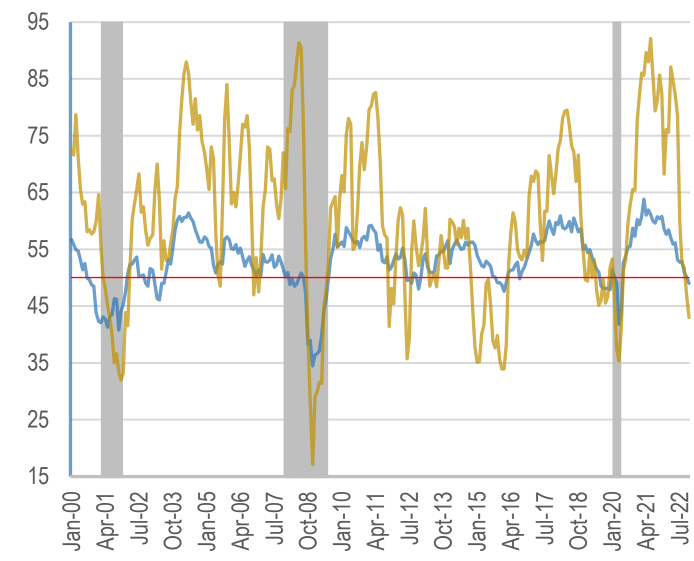
Slowdown Ahoy

Approximately 85% of economic growth in the United States comes from services instead of products (manufacturing). Last week, the Institute of Supply Management (ISM) released its prospective analysis of the future of both areas. We watch this data closely as it tends to be forward-looking, whereas most economic data look backward. Readings above 50 suggest expansion, and below 50, contraction.

The blue line in the graph below shows the US manufacturing sector in contraction following a re-

US Manufacturing PMI (Blue) and Prices Paid (Gold)

January 1, 2018 - January 5, 2024
(Source: Bloomberg)



markable expansion during the pandemic free-money bonanza period. The gold line represents pricing in US manufacturing. According to this data, manufacturing prices have entered a contractionary phase. Lower costs, high inventory, and softening demand will lower prices and contract margins, eventually lowering manufacturing companies' profits.

Conclusion

That's it for this holiday-shortened *Weekender*. Next week look for our summary of the *House View* for 2024.