December 2023

MONTHLY MARKET INSIGHTS

Key takeaways:

- The S&P 500 and Nasdaq posted strong returns bolstered by a notable drop in benchmark interest rates.
- Fed fund futures are now pricing in 125 basis points ("bps") of rate cuts in 2024.
- December seasonality, known as the "Santa Clause" rally, could support equity market momentum into year-end.

November was a stellar month for US equities as the S&P 500 returned 9.1% while the Nasdaq returned 10.8%, on a total-return basis.[1] The month was defined by a noteworthy fall in US benchmark rates, creating a strong tailwind for stock valuations. The US 10-year treasury yield dropped 60 basis points ("bps") over the month, closing at 4.33%, as benign inflation readings led investors to grow optimistic that the Federal Reserve ("the Fed") has concluded its rate-hiking campaign and will begin cutting rates next year.[2]

Investor optimism that the Fed will be able to tame inflation without inducing a recession has been a major catalyst for the strong rally in markets through November. On November 14, the headline consumer price index ("CPI") decelerated to 3.2% year over year from the 3.7% year-over-year rate recorded in September, coming in below Factset expectations of 3.3%. A significant contributor to the slowdown in headline CPI was the gasoline index decreasing by -5% over the month, reversing a 2.1% increase in September. Conversely, monthly shelter costs continued to tick higher. Core CPI, which excludes the more volatile food and energy categories, came in at 4% year-over-year, higher than the headline number, but below consensus expectations of 4.1%. Significant disinflation is occurring at the same time that economic growth remains resilient. Economists' estimates suggest that US real GDP in the fourth quarter is currently tracking around 2%, reflecting a decline from the previous quarter but still supporting the possibility of a soft landing scenario.[3]

Encouraging inflation news has led markets to price in an increasing likelihood that the Fed will cut rates next year. Market pricing at the end of November indicates that the Fed may begin cutting as soon as March 2024, with futures implying 125 basis points in cuts over the next year.[4] The perceived capitulation in monetary policy encouraged a risk-on environment throughout November, with growth sectors outpacing defensive sectors over the month as valuations expanded. Information technology, led by the Magnificent 7,[5] returned 12.87% over the month, with defensive sectors like healthcare proving laggards. Similarly, the sharp drop in long-end yields proved particularly beneficial for long-duration bonds, which returned 9.92%, as measured by the iShares 20 Plus Year Treasury Bond ETF.[6]

While inflation has come down significantly from its peak in June 2022, we believe that the Fed still has a lot of work to do before core inflation reaches the Fed's 2% target. Heightened geopolitical tensions in the Middle East will likely spur increased volatility in energy commodities that could reverse price declines experienced in the last reading. Sticky shelter inflation will be problematic for the Fed, especially considering the historic supply-demand mismatch in the US housing market. A tight labor market should continue to support wage inflation, despite

1. Bloomberg. Total return, assumes dividend reinvestment into the index.
2. Bloomberg.
3. Strategas. Investment Strategy. Mon. Nov. 20, 2023
4. Cox, Jeff. Here's what it would take for the Fed to start slashing interest rates in 2024. CNBC, November 29, 2023.
5. The "Magnificent 7" refers to seven of the largest S&P 500 companies; specifically, Alphabet (GOOG, GOOGL), Amazon (AMZN), Apple (AAPL), Meta Platforms (META), Microsoft (MSFT), Nvidia (NVDA, and Tesla (TSLA).
6. Bloomberg.

the fact that jobless claims and unemployment have been creeping upwards. With that said, we believe the bond market may be prematurely declaring victory over inflation, and that rates will likely remain in restrictive territory for longer than is currently reflected in the market. On December 1, Chairman Powell pushed back on market expectations for aggressive interest rate cuts in prepared remarks for an audience at Spelman College in Atlanta.[7] The Chairman stated that the Federal Open Market Committee intends to maintain a restrictive level of interest rates until inflation is meaningfully closer to its target, and that it was too early to speculate on when policy might ease. We believe this supports a "higher-for-longer" interest rate environment that will potentially disappoint market expectations and possibly cause markets and rates to revert next year.

Although we believe the current optimism of the market is overblown, the seasonality of December, often referred to as the "Santa Claus" rally, creates a strong backdrop that we believe will lead equities to perform well into year-end. December has historically proven to be a strong month for US equities, even following a strong November. An encouraging showing from the consumer after Thanksgiving, as seen through Black Friday sales data, foreshadows better-than-expected holiday spending that we believe will support stocks. US retail sales on Black Friday rose 2.5% from last year, according to MasterCard SpendingPulse, which measures sales in stores and online, and foot traffic at US retailers rose 2.1% according to store traffic analytics provider RetailNext.[8] Additionally, with the Fed likely to hold rates in its December meeting, benchmark yields should stay at recently depressed levels, supporting risk assets through year-end.

The US economy and equity markets have performed better than we expected in 2023. Investors have proven optimistic that the economy will remain resilient amid policy tightening and that inflation will revert to normal levels without economic contraction. We remain skeptical of the soft landing scenario, as we believe many of the lagged effects of monetary policy tightening remain to be felt. A new "higher-for-longer" interest rate environment will create a challenging financing environment for corporations and households alike. We find it unlikely that the labor market will rebalance by cutting only job openings and that wage inflation will revert without a significant increase in unemployment. Taken together, we maintain a cautious outlook towards both the economy and capital markets, and we continue to prioritize capital preservation in client portfolios.

7. Cox, Jeff. Fed Chair Powell calls talk of cutting rates 'premature' and says more hikes could happen. CNBC, November 29, 2023.

8. Kapner, Suzanne. Black Friday Spending Was Strong. How People Pay for Gifts Is Upending Retailers. Wall Street Journal, November 26, 2023.

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