February 2024

MONTHLY MARKET INSIGHTS

Key takeaways:

- After some profit-taking to start the year, the S&P 500 made a new all-time high on January 19th for the first time in two years.
- While the Federal Reserve (the "Fed") remains on course to start cutting rates soon, during his latest post-Fed-meeting press conference Chairman Powell said such action is unlikely to commence in March.
- Fourth quarter GDP growth was much stronger than consensus expectations at 3.3% to cap a remarkable year for the US economy.

US stocks generally fared well in January, with the S&P 500 Index registering its first all-time high since early 2022. For the month, the S&P gained 1.59%, and the Nasdaq rose 1.02%, although the small-cap Russell 2000 Index suffered a decline of -3.93% and the S&P 500 Equal Weight Index declined -0.9%. The broadening stock participation witnessed during the late 2023 market surge led to a narrowing rally led by large-cap tech, financials, and healthcare. Overall, the "Magnificent Seven" did well, but as expected, there has been a dispersion of returns within the group. NVDA, META, and MSFT strongly outperformed, while AAPL and TSLA finished the month sharply in the red. Ten-year yields spent most of the month retracing some of the fourth quarter's swoon but ended the month up only seven basis points to 3.95%. The US dollar was broadly stronger, especially against the yen, and WTI crude rose 5.9%, breaking a three-month decline.

Equity prices continue to be supported by the soft landing narrative that took hold late last year, along with the prospects for lower rates. The recently released fourth-quarter GDP report points to a resilient economy that grew 3.3% for the quarter and over 3% for all of 2023. Growth in the quarter was primarily led by consumer spending and exports, with contributions from government spending, inventories, and residential and non-residential fixed investment.[1] The consumer continues to be a bright spot for the US economy, and we see no change to this pattern as long as the labor market remains firm.

Despite strong economic growth, disinflation continues apace. The latest Personal Consumption Expenditures ("PCE") inflation report showed that core PCE slowed to 2.9% year-over-year, well above the Fed's 2% target. Still, both the 3-month and 6-month averages are running at or below 2%. We believe this gives the Fed enough ammunition to start cutting rates this spring. However, in the post-Fed-meeting press conference on January 31, Powell suggested that it is unlikely the Fed will start cutting rates in March. This revelation disappointed investors, and stocks had their worst day since October on the last day of the month. Whether the first cut comes in March or in May, the prospects for lower rates should keep any equity softness to a minimum.

With respect to the Fed's quantitative tightening ("QT") program, Powell said that the Fed would commence in-depth discussions about the QT process at its next meeting in March. We believe this means the Fed will most likely start winding down its QT program in the summer, reducing another headwind for stock prices.

1. "News Release." Gross Domestic Product, Fourth Quarter and Year 2023 (Advance Estimate) | U.S. Bureau of Economic Analysis (BEA), 25 Jan. 2024, www.bea.gov/news/2024/gross-domestic-product-fourth-quarter-and-year-2023-advance-estimate.

While we believe stock prices should perform well, sentiment and valuation should cap upside in the near term. In our view, investors have now bought into the "Goldilocks" scenario where inflation will keep trending towards 2%, allowing the Fed to cut rates by 150 basis points in 2024, which should keep economic growth steady. The odds of such an outcome have risen, but any unforeseen hiccup to this thesis will likely bring some selling pressure to equities. Valuation is also becoming more of a concern. The S&P 500 closed the month trading at a forward 12-month P/E ratio of 20, higher than the 5-year average of 18.9 and the 10-year average of 17.6, despite today's higher rate environment.[2] Furthermore, the forward P/E ratio is based on consensus earnings growth of 11.2% in 2024, and we believe that number will likely to disappoint given the current environment.[3]

Overall, the path of least resistance for equities is higher, but much good news is already reflected in the current S&P 500 price. So far, this year's advance has been narrow, reminiscent of how the market behaved most of last year. A few themes, like artificial intelligence and weight-loss drugs, continue to dominate the discourse while the rest of the market struggles to find its footing. Normally, a strong economy and disinflation is a recipe for small-cap outperformance, but investors continue to crowd into a limited number of large-caps. If Goldilocks proves correct, small-caps could be on the verge of something special.

2. Butters, John. Earnings Insight, Factset, 2 Feb. 2024, insight.factset.com/hubfs/Resources/Research%20Desk/Earnings%20Insight/EarningsInsight_041417.pdf.

3. Id.

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