Weekly market wrap

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Five takeaways from February's

strength

Key Takeaways:

- *February showed us is that if yields are rising for the right reasons (stronger growth instead of Fed rate hikes), equities can do well in that environment.*
- *The fourth-quarter earnings season has been strong, suggesting that a reacceleration is underway, supporting the new highs in stocks.*
- *Bonds declined for the second straight month, but we think the rise in yields offers a good entry point for investors to consider extending duration.*
- *A few of the Magnificent 7 stocks have started lagging the S&P 500, potentially indicating that leadership will broaden ahead. We see opportunities to diversify equity positions.*
- *Fed rate cuts will help prolong the expansion and drive further gains, but markets could get choppier in the short term, as the bar of expectations is high.*

Rising markets and low volatility rank high on investor's wish lists, and over the past four months we've been fortunate to experience precisely that. Not only did the S&P 500 rise 5% last month, marking the fifth-strongest February gain since 1980, but also the world equity market hit an all-time high, as several key equity indexes around the globe reached record levels. This included the German DAX, the French CAC, and Japan's Nikkei, which after 34 years, surpassed its prior high set in 1989[1].

Give Feedback

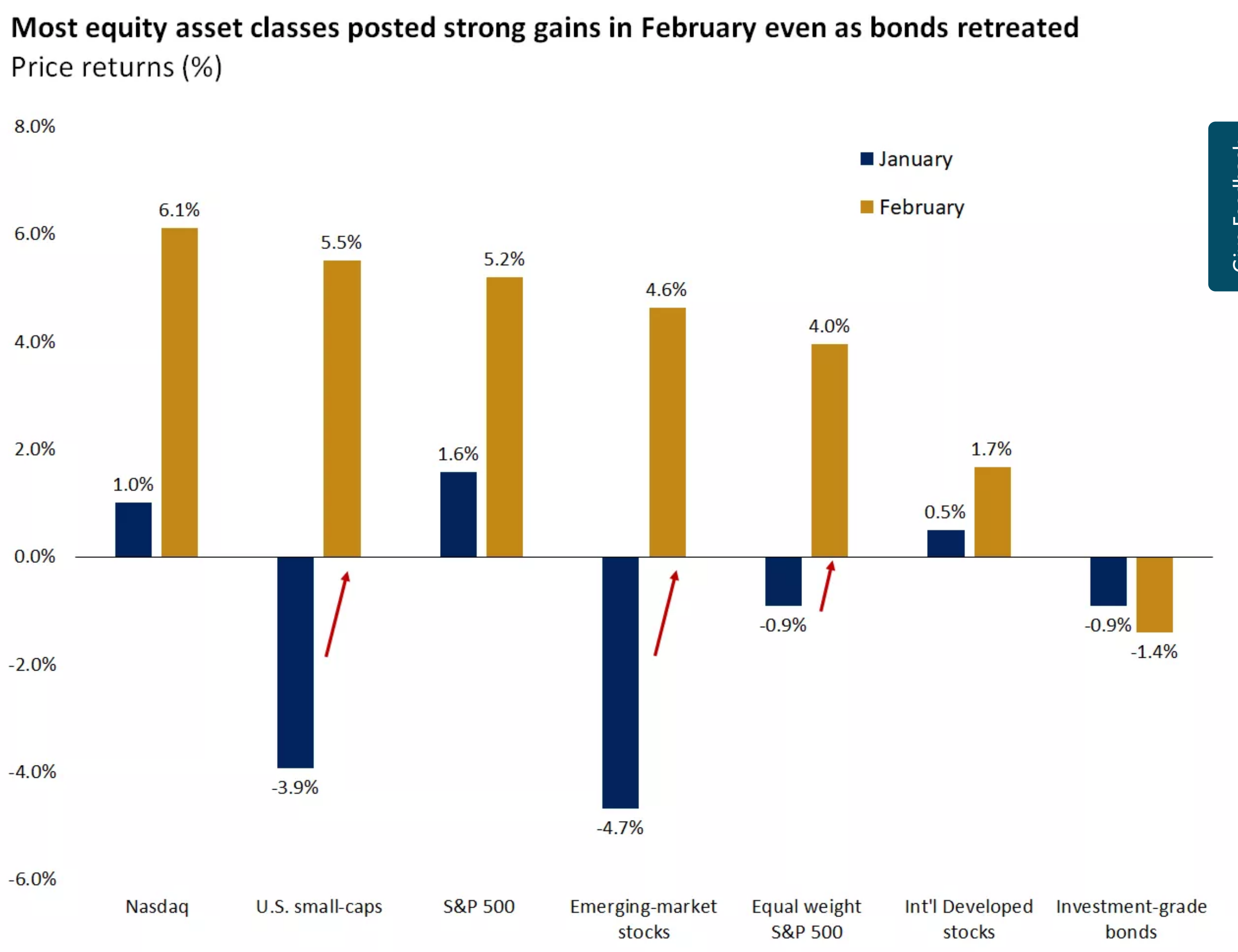
However, February's market performance was not without blemishes, as bonds were pressured by a renewed rise in rates, and the benefits of diversification across different equity asset classes beyond U.S. large-cap stocks were not obvious. We believe that these blemishes are what present opportunities for investors over the balance of the year. Here are five takeaways from February's market performance:

1. **Equities performed well despite the rise in rates**

   Unlike several periods last year when the rise in yields triggered a pullback in equities, global stocks were able to power through and advance in the face of a renewed uptrend in short- and long-term rates. We believe there are three reasons for this welcomed resilience: 1) a strong showing in fourth-quarter corporate earnings results (more on that below); 2) renewed enthusiasm around AI, sparked by NVIDIA's outlook; and 3) robust economic growth.

On the latter, the second estimate for fourth-quarter GDP showed that the U.S. economy grew 3.2%, slightly below the 3.3% initial estimate, though consumer-spending growth was revised higher at 3%[1]. Despite high borrowing costs and last year's inflation spike, the consumer has continued to spend at a robust pace, not only helping keep the economy out of recession, but also supporting above-average growth. In addition, productivity growth has accelerated, initial jobless claims remain low, and the worst of the tightening in lending conditions and contraction in manufacturing activity appears to be in the rearview mirror.

The outperformance of the growth-sensitive small-cap stocks in February and the breakout of the retail industry index after staying rangebound for about two years are signs that investors are starting to get more confident about the sustainability of the economic expansion. We think the optimism about the cycle is warranted, but we expect growth and bond yields to moderate in the quarters ahead. Nonetheless, February showed us that if yields are rising for the right reasons (stronger growth instead of Fed rate hikes), equities can do well in that environment.



Source: Bloomberg.

Chart description

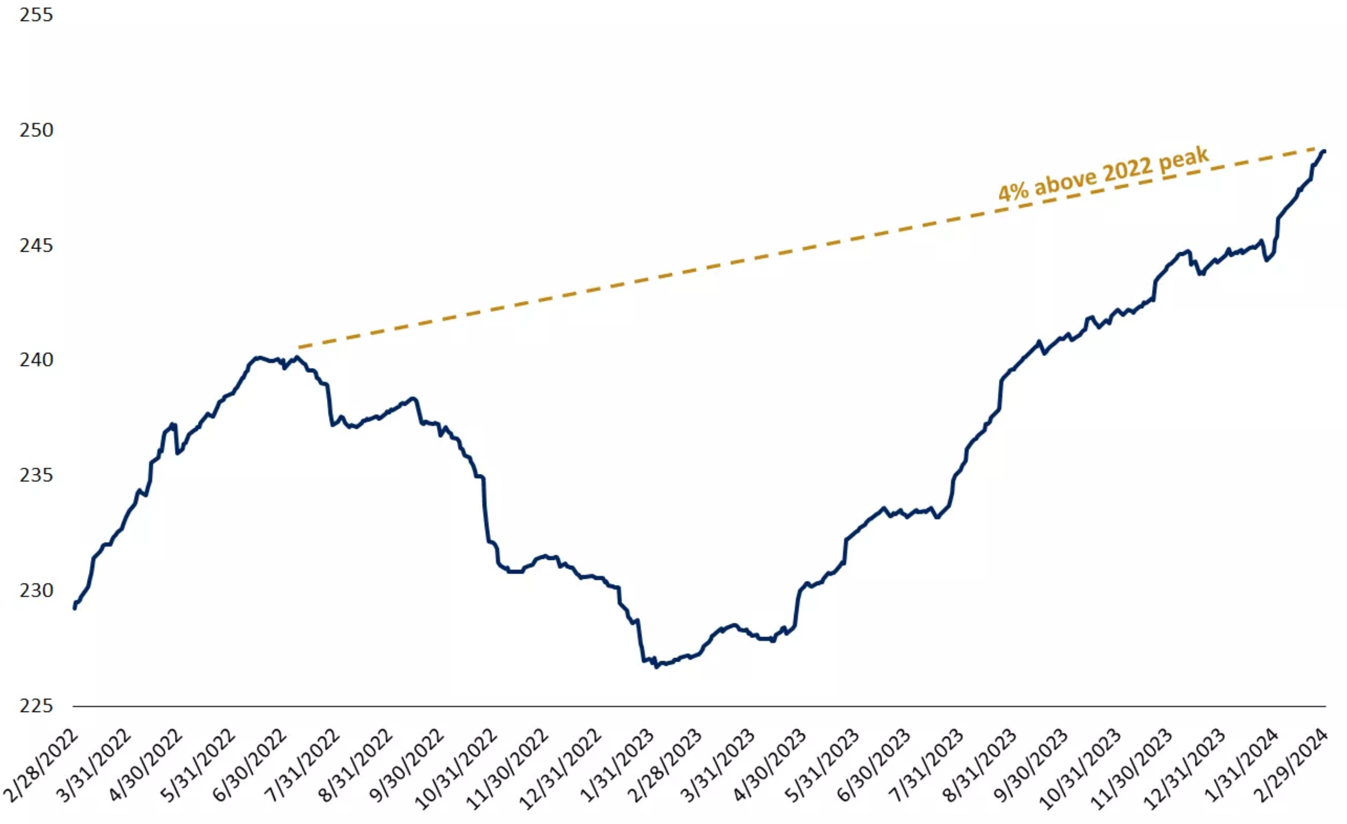
2. **Fresh highs were not only limited to stock prices, but also earnings**

Because the rally in stocks since last year has been primarily driven by an increase in valuations, we think that further gains will likely have to come from an increase in corporate profits. The good news on that front is that this earnings season has been particularly strong, suggesting that a reacceleration is underway.

With about 90% of the S&P 500 companies having already reported results, revenue is growing at 3.8% and earnings growth is tracking a solid 7.5%[1]. Much of that is driven by a narrow group of mega-cap tech companies, but results have surprised positively across the board. And, looking ahead, the cyclical sectors might see an improvement in the second half of the year as the Fed pivots to rate cuts. Backed by healthy economic growth, the forward 12-month earnings estimate for the S&P 500 is now at a new high, about 4% above the prior peak in June of 2022[2].

The upshot is that rising earnings suggest that the uptrend in stocks will continue, though with possibly more volatility. As the earnings season winds down, the focus will now shift back to the economic data and the Fed's meeting in March, which will include updated economic and interest-rate projections. Investors will also be keeping an eye on the government-funding deadlines, which are now set for March 8 for some agencies, and March 22 for the rest, to avoid a shutdown.

Q4 results have helped forward 12-month S&P 500 earnings rise to new highs



Source: FactSet, Edward Jones.

Chart description

3. **Bonds post second straight monthly loss; rise in yields offers another entry point**

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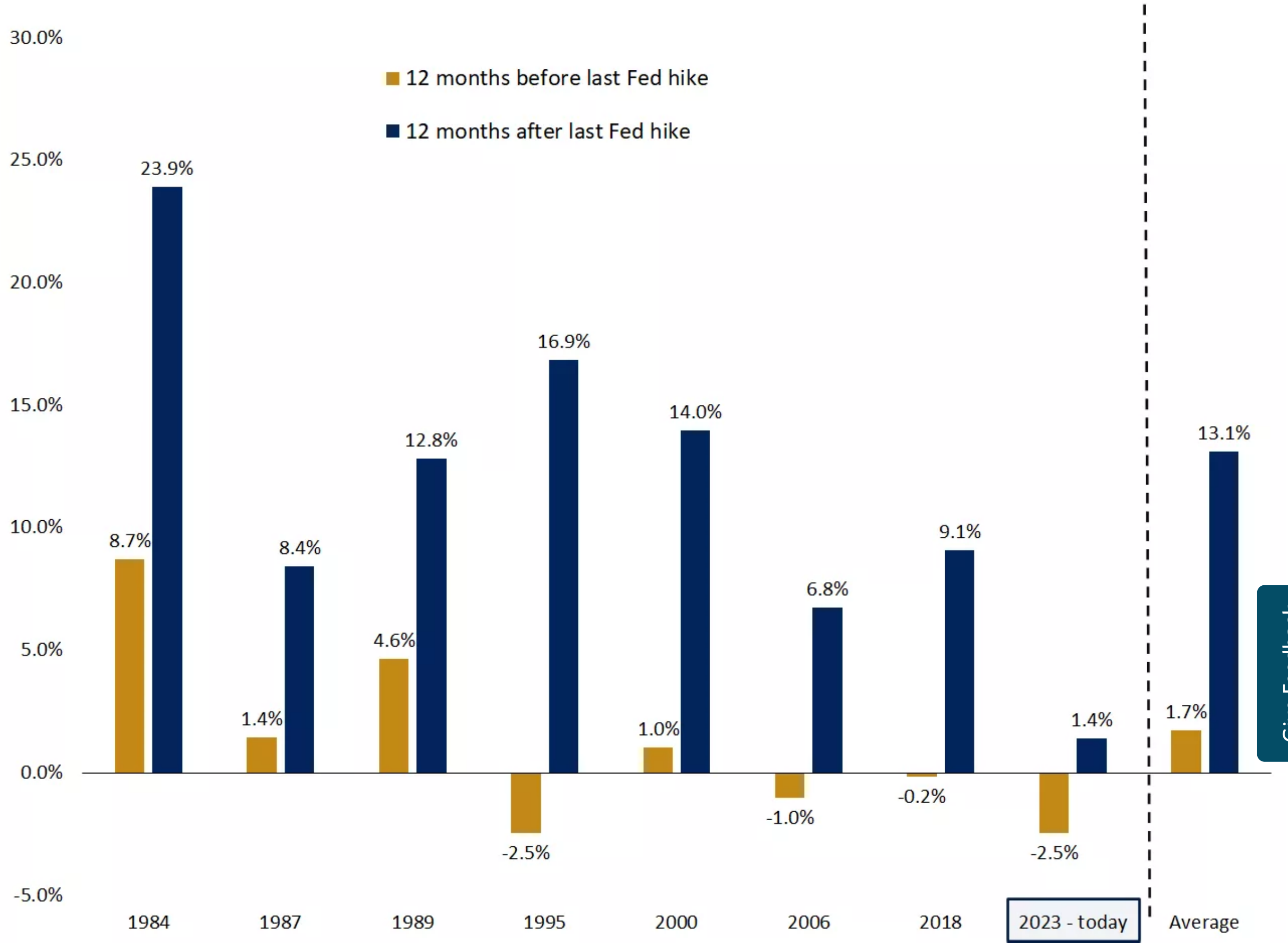
Offsetting some of the gains in balanced portfolios was that investment-grade bond prices declined in February, driven by upside surprises in the January consumer and producer prices, and a shift in rate-cut expectations. Robust economic growth and a bumpy "last mile" of inflation mean that the Fed will not be in a rush to ease policy. As a result, the six rate cuts that were priced in by the markets at the start of the year have been reduced to three, now lining up with the Fed's and our own projections[1].

In our view, the path of inflation remains lower, driven by an expected moderation in housing costs and slower wage growth. The core PCE (personal consumption expenditures price index), the Fed's preferred measure of inflation, has been below 3% over the past two months and may not be far from the 2% target by the end of the year. This expected cooling will likely allow the Fed to start cutting rates possibly in June and deliver three to four cuts.

With investor expectations now having aligned with what we think is a more realistic path of rates, we see another opportunity to consider extending the duration of fixed-income portfolios. While we are not dismissing the risk of the potential for inflation to settle at a higher rate than policymakers are comfortable with, we believe that the comeback in bonds that we saw late-last year may just be getting started. As the Fed embarks on a multiyear rate-cutting cycle, the path of least resistance for rates will be lower. For those that are overweight in CDs and short-term bonds, we recommend considering taking advantage of February's uptick in yields to rebalance allocations to intermediate- and long-term bonds.

Bond performance around the end of major Fed tightening cycles



Source: Morningstar Direct, Edward Jones.

Chart description

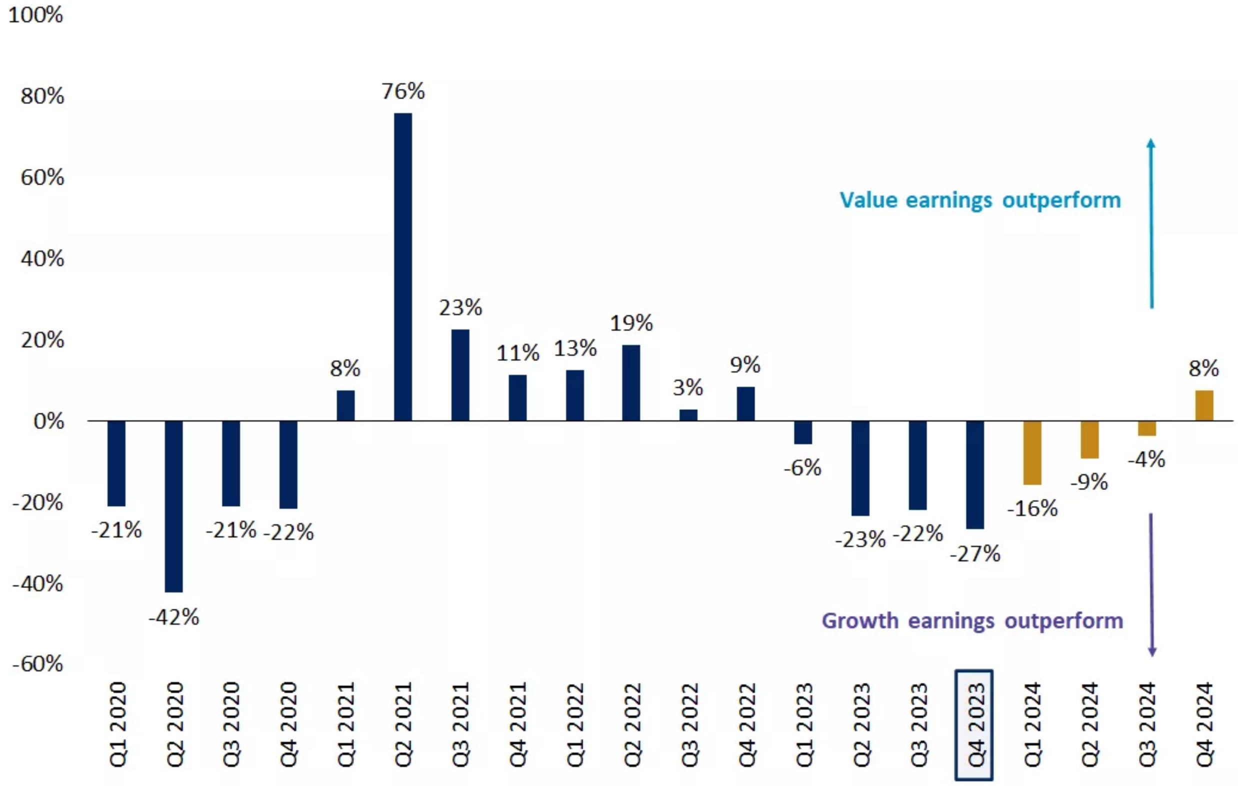
4. **Magnificent 7 may be ready to relinquish leadership**

Since early 2023, the increasing concentration of the U.S. equity market has become synonymous with the Magnificent 7 stocks. But even this elite group of mega-cap tech companies became more concentrated in February. Microsoft, Apple and Alphabet lagged the S&P 500 gains last month, while Tesla is down about 18% year-to-date. That leaves NVIDIA, Meta, and to a lesser extent Amazon driving the bulk of the relative gains[1].

We expect leadership to broaden over the course of the year as investors start looking for opportunities in segments of the market that have lagged. That includes value-style investments, as well as mid- and small-cap stocks, that up until recently have been overlooked. The three conditions that are likely needed and that will likely be in place later this year for the leadership rotation to materialize are

- A Fed pivot to rate cuts that will provide support to the interest-rate-sensitive sectors;
- Improvement in the manufacturing PMI and other survey-based growth measures, which have been signaling caution for more than a year now; and
- A narrowing in the earnings outperformance between the mega-cap tech and the rest of the market.

Q4 may mark the peak in growth earnings outperformance relative to value
Russell 1000 Growth vs. Value index earnings comparison



Source: FactSet, Edward Jones.

Chart description

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5. **Bull market gains are not exhausted, but stocks may be due for a breather**

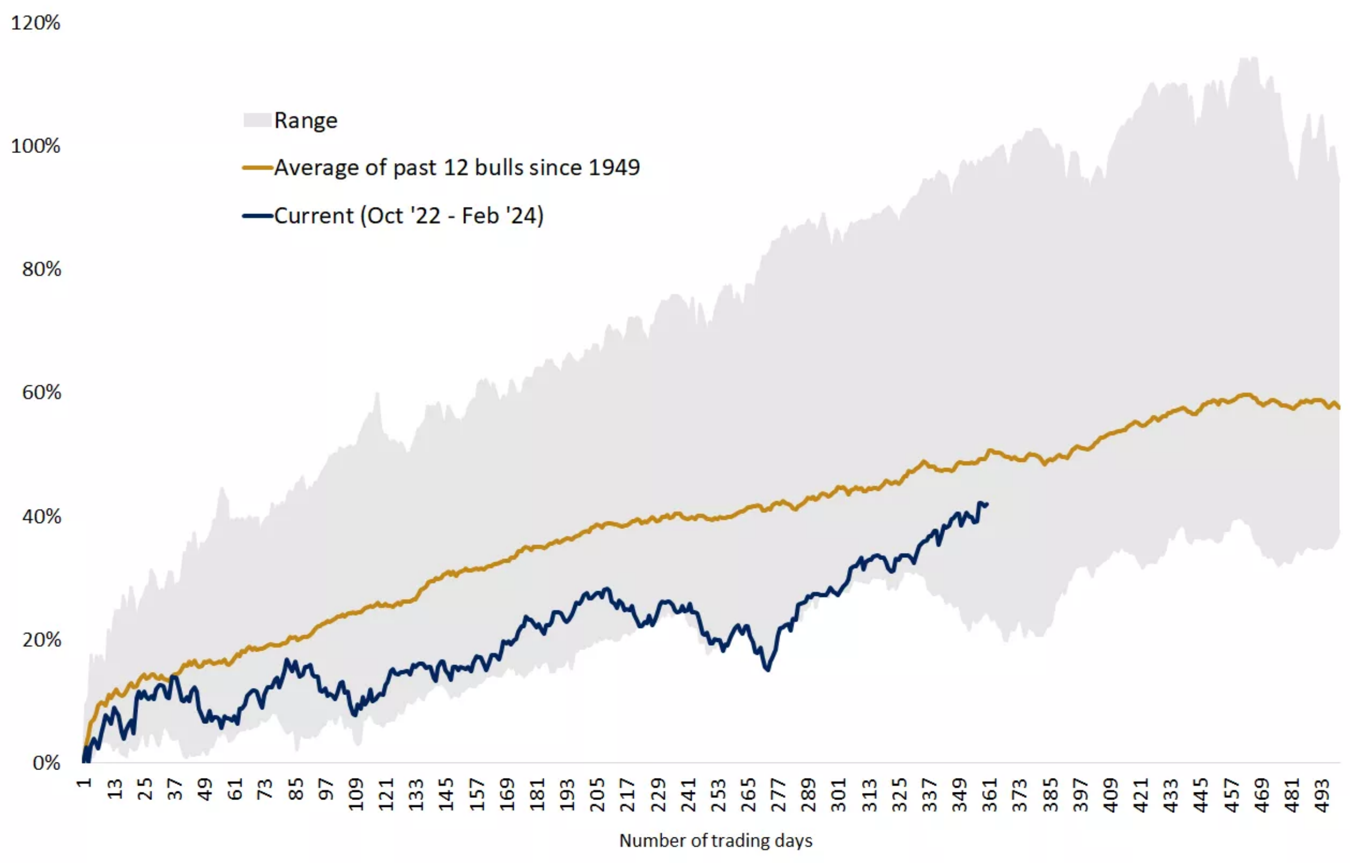
The uninterrupted nature of the rally over the past four months is supported by an improved outlook for the economy, earnings and inflation. Nonetheless, it also sparks concerns about whether it's overextended. History suggests that there is further upside, but that the pace of gains will likely slow and that volatility might pick up.

Examining the past 12 bull markets going back to 1949, stocks have gained on average about 50% in the first 16 months of the advance, vs. the 42% gain since the October 2022 low[2]. Prior to the last four-month rally, the current bull was one of the weakest on record. As Fed policy becomes less restrictive over time, this will likely prolong the expansion and drive further gains.

However, stocks don't move in a straight line. As investors periodically get reminded, when the pendulum swings towards optimism, markets tend to turn choppier, as the bar of expectations is high. Based on the various indicators that we track, investor sentiment has turned significantly more bullish over the past 12 months, which, as a contrarian indicator, signals some caution. But the readings are not at extremes yet.

Investors might be well served keeping realistic expectations for returns and volatility. An average year tends to see three 5% pullbacks and one 10% correction. However, if the economy stays out of recession, inflation continues to moderate, and the Fed gradually lets off the breaks, the pullbacks will likely prove to be short-term dips. And despite the new highs in equities, we see opportunities to diversify equity positions and to consider extending duration within fixed-income portfolios.

The current bull market gains are not outsized relative to history
S&P 500 returns in the first two years of a new bull market



Source: FactSet, Edward Jones.

Chart description

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Investment Strategist

Sources: 1. Bloomberg, 2. FactSet

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Weekly market stats

INDEX	CLOSE	WEEK	YTD
Dow Jones Industrial Average	39.087	-0.1%	3.7%
S&P 500 Index	5,137	0.9%	7.7%
NASDAQ	16,275	1.7%	8.4%
MSCI EAFE*	2,303.90	0.7%	3.0%

INDEX	CLOSE	WEEK	YTD
10-yr Treasury Yield	4.18%	-0.1%	0.3%
Oil ($/bbl)	$79.74	4.2%	11.3%
Bonds	$97.53	0.2%	-1.6%

*Source: FactSet, 3/1/2024. Bonds represented by the iShares Core U.S. Aggregate Bond ETF. Past performance does not guarantee future results. *Morningstar Direct 3/4/2024.*

The week ahead

Important economic data being released this week includes the ISM services PMI and the nonfarm payrolls report.

Review last week's weekly market update.

Angelo Kourkafas

Give Feedback

Angelo Kourkafas is responsible for analyzing market conditions, assessing economic trends and developing portfolio strategies and recommendations that help investors wor toward their long-term financial goals.

He is a contributor to Edward Jones Market Insights and has been featured in *The Wall Street Journal, CNBC, FORTUNE magazine, Marketwatch, U.S. News & World Report, The Observer* and the *Financial Post*.

Angelo graduated magna cum laude with a bachelor’s degree in business administration from Athens University of Economics and Business in Greece and received an MBA with concentrations in finance and investments from Minnesota State University.

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Market Data

DJIA 38,661.05 ↑ (+75.86)

S&P 500 5,104.76 ↑ (+26.11)

NASDAQ 16,031.54 ↑ (+91.96)

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