Weekly market wrap

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Mid-'90s vibes

Key Takeaways:

- As most central banks are eyeing the start of rate cuts in the months ahead, investors are hoping for a soft landing for the rally to continue.
- We think the mid-1990s provides a relevant analogue to today's investment backdrop. Easy financial conditions and an uptick in productivity could aid economic growth and support sentiment. But a pivot to rate cuts could also fuel speculation.
- We expect this environment to be supportive for both stocks and bonds, but, in our view, the greater opportunity lies within equities, particularly in areas of the U.S. market that have lagged and carry lower valuations.

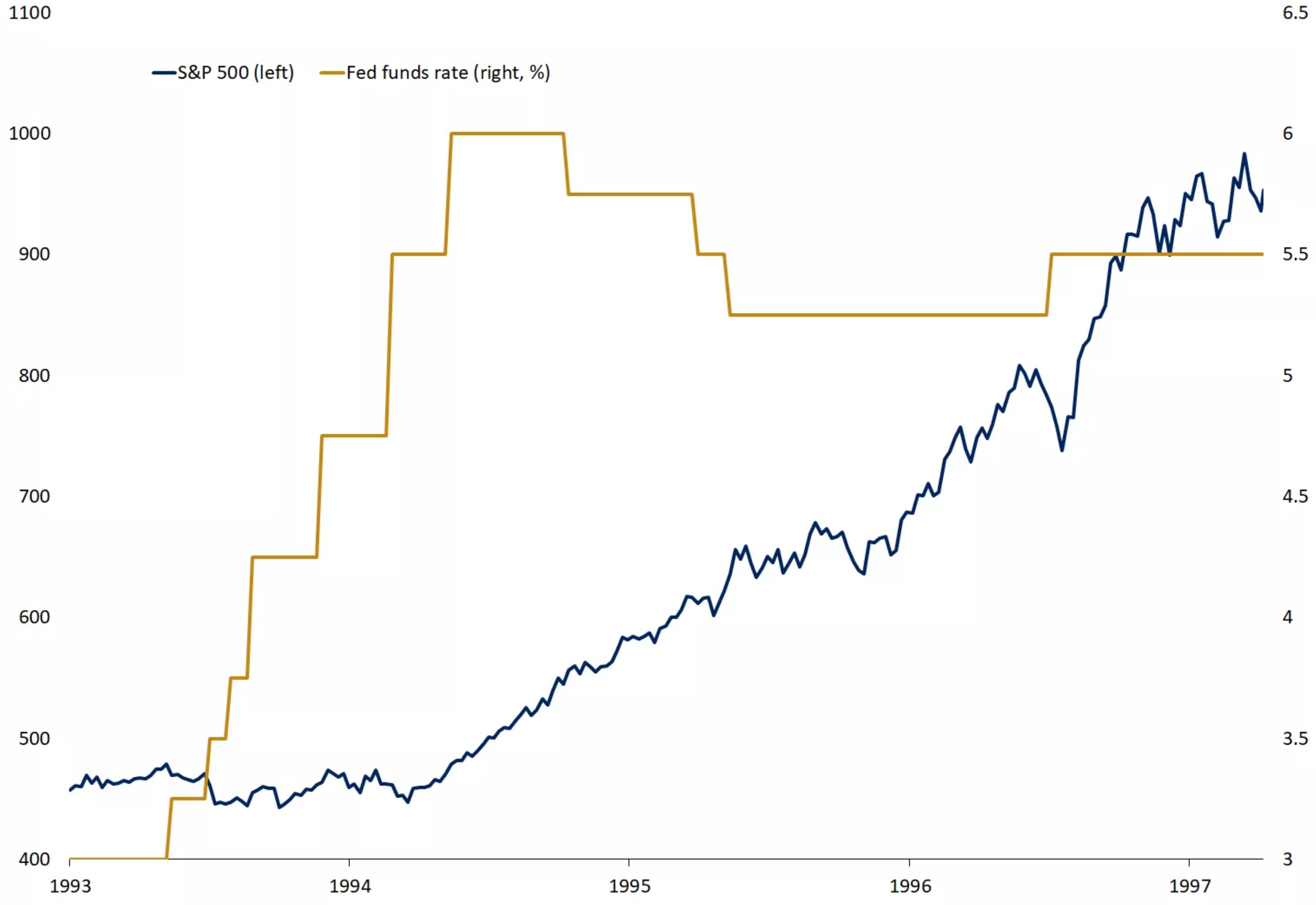
In 1995 Toy Story was released, Gangsta's Paradise was the No. 1 song on Billboard, and the Dow closed over 5,000 for the first time. Supporting the start of a multiyear historic rally in stocks at that time was a successful Fed pivot to rate cuts after a series of aggressive hikes, which was later labeled as a textbook example of a soft landing. The economy escaped a Fed tightening cycle without entering a recession and with the labor market staying strong.

Fast forward to today. Both investors and the Fed are hoping to achieve a similar outcome, as most major central banks are eyeing the start of rate cuts in the months ahead. We examine the similarities and differences in the macroeconomic backdrop between now and the mid-'90s and offer our views of where the opportunities lie.

Cutting rates when financial conditions are easy is a good recipe for a soft landing.

- **Mid-'90s:** To prevent an overheating economy from driving up inflation, the Fed under Alan Greenspan doubled interest rates from 3% to 6% in a little over a year between 1994 and 1995. The S&P 500 declined 1.5% in 1994, the economy slowed for a couple of quarters to below-trend growth but stayed clear of a contraction, and inflation held steady, hovering around 2.5% -3%[1]. Subsequently, the Fed eased monetary policy in 1995 by cutting rates three times, a similar number of cuts to what Fed officials project for 2024. Financial conditions are a gauge of market stress and capture factors such as stock prices, the U.S. dollar, market volatility and credit spreads. When the Fed cut rates for the first time during that cycle in 1995, financial conditions were already easy, and the rate cuts further aided economic growth and supported sentiment. What followed was a soft landing.

The Fed managed to achieve a rare soft landing in 1994-1995

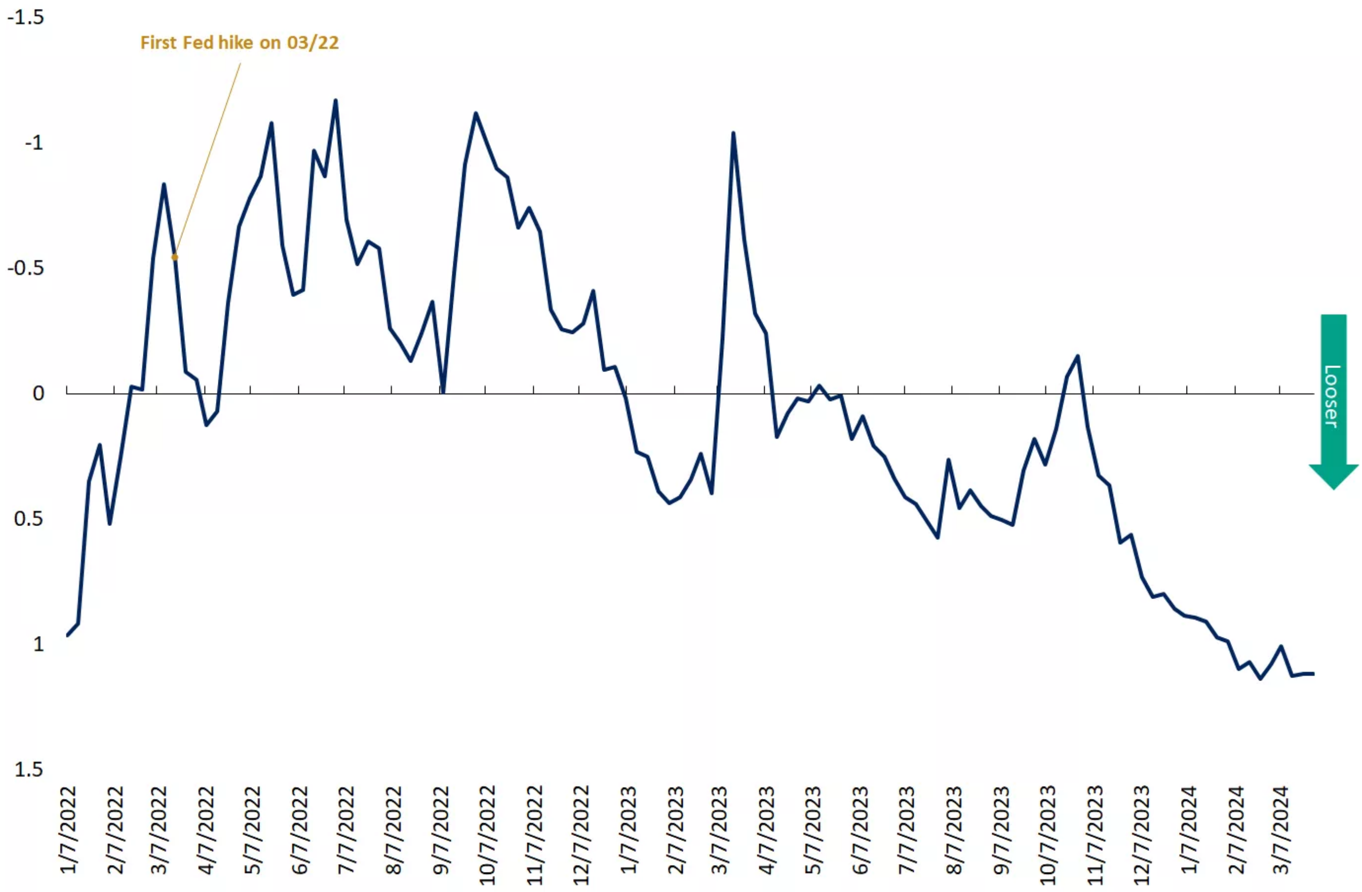


Source: Bloomberg, Edward Jones

Chart description

- **Now:** In this tightening cycle, the Fed hiked rates by 5.25% from March 2022 through July 2023 to tame inflation. While the hikes were more severe than in 1995, the destination was similar, with the fed funds rates peaking at 5.5% (absent a surprise resumption of rate hikes). And like 1995, as the Fed is looking to start letting off the brakes, financial conditions are supportive, giving credence to the soft-landing scenario. In fact, the Chicago Fed and Bloomberg financial-condition indexes both indicate that conditions are now easier than they were when the Fed started raising rates two years ago. In the past, it is when financial conditions were tight that recessions have occurred, which is not the case today[1]. Stocks are making fresh record highs, creating a wealth effect; the U.S. dollar is off its peak; volatility is subdued; and credit spreads are near historic lows.

Financial conditions are looser now than they were before the Fed started hiking
BBG financial conditions index



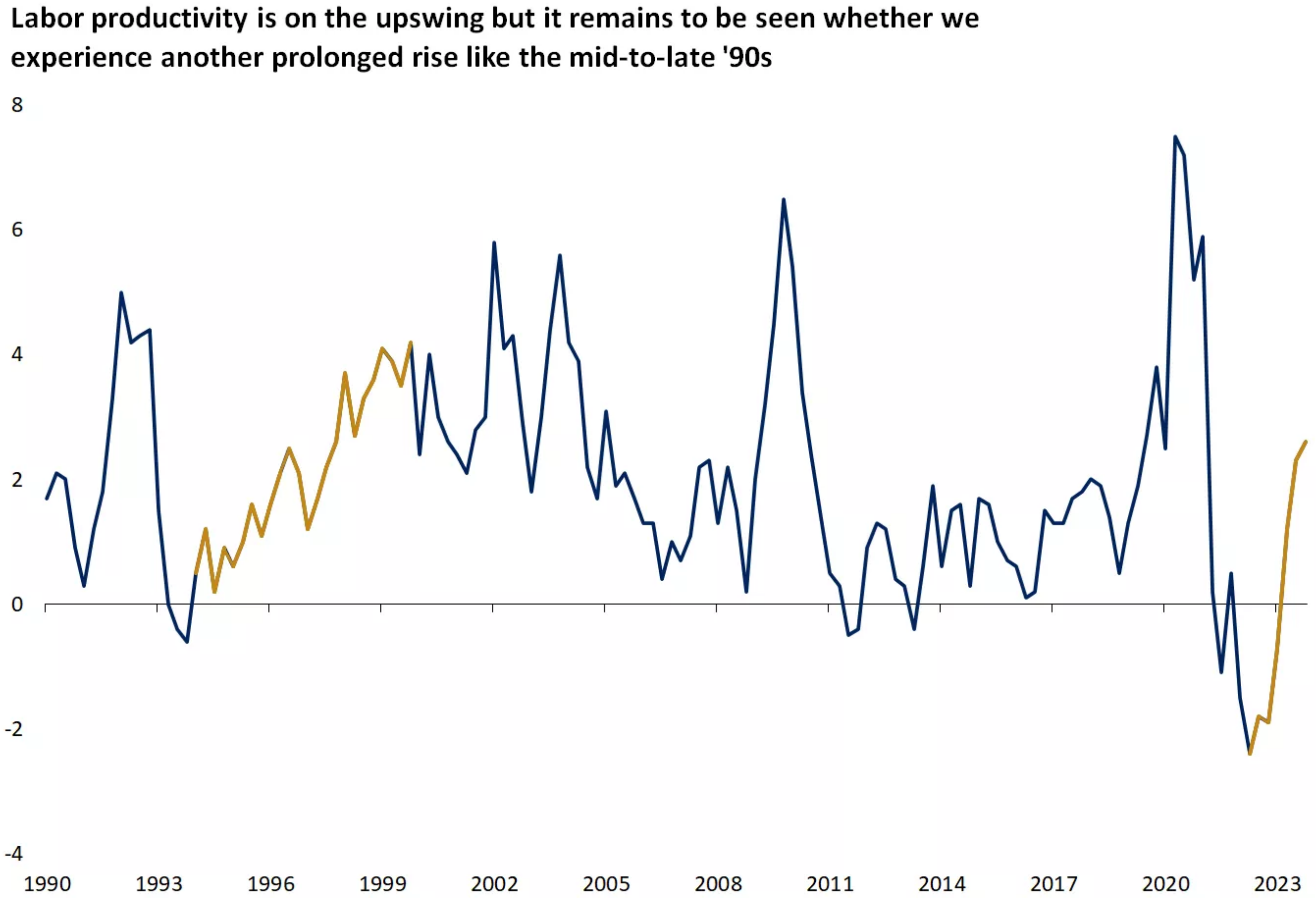
Source: Bloomberg, Edward Jones.

Chart description

Productivity is the secret sauce that can help drive higher growth and lower inflation.

- **Mid-'90s:** In addition to a strong labor market that aided consumer spending in the face of Fed rate hikes, a unique characteristic of the second half of the 1990s was a sustained rise in productivity. Labor productivity accelerated from 0.7% in 1994, to 2% in 1996, and 3.3% in 1998, on the back of globalization and the wide adoption of computers and the internet[1]. For perspective, 1996 was the first year when more emails were sent in the U.S. than postal mail[2].

- **Now:** Another reason why the mid-'90s analogue is relevant today is the enthusiasm around artificial intelligence (AI) and the hope that it will drive a similar lasting boost to productivity. Over the past year productivity has picked up nicely, helping accelerate economic growth and lower labor costs per unit of output. It is premature to attribute this encouraging trend to AI, but the adoption of technology during the early pandemic years amidst labor shortages is likely playing a role in helping companies be more efficient. We don't think that AI will be a magic wand that will transform the economy overnight, but we see the potential to enhance productivity in the second half of this decade.



Source: Bloomberg, Edward Jones

Chart description

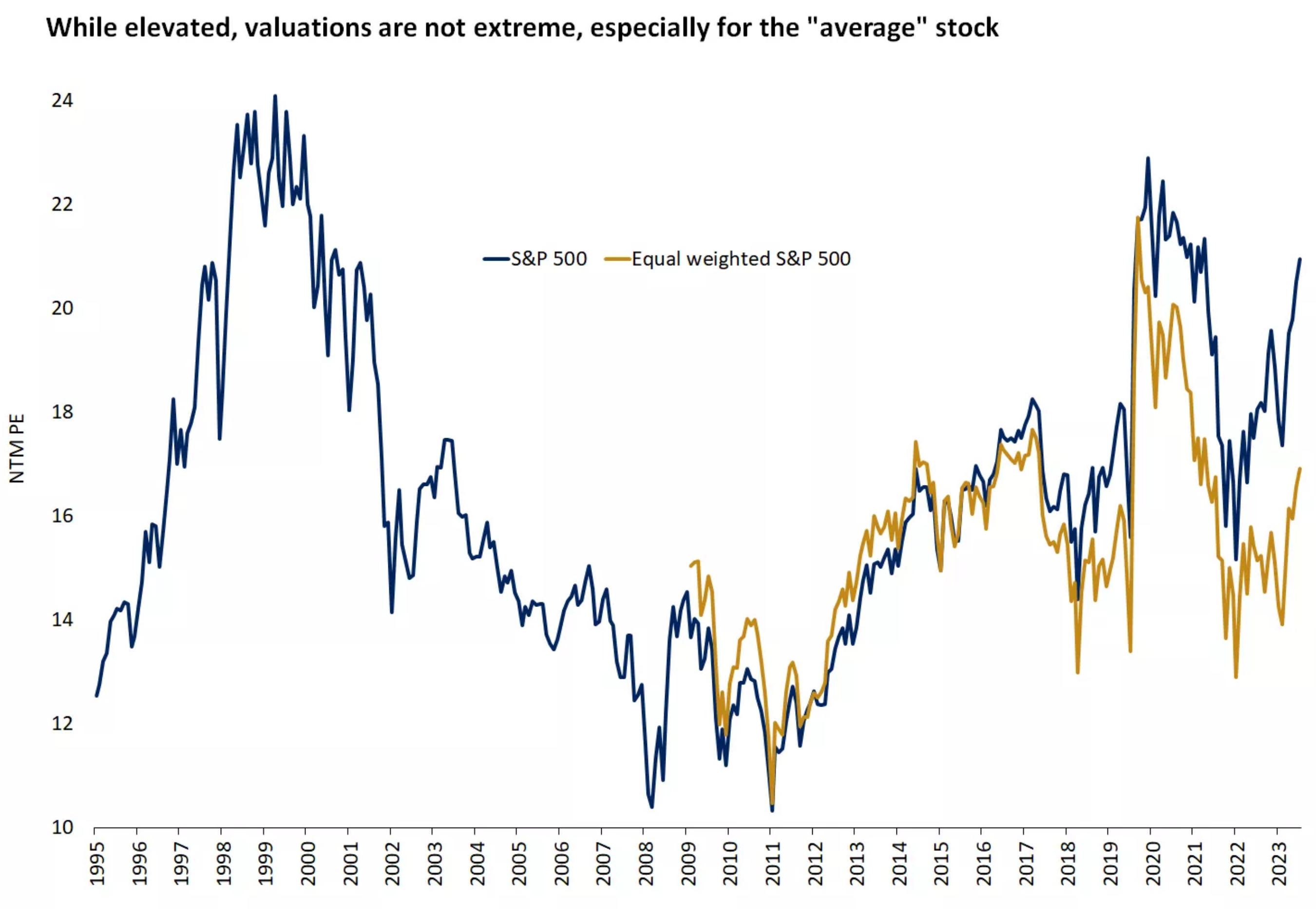
The caveat: Additional liquidity might fuel speculative bubbles.

- **Mid-'90s:** Easy financial conditions, the Fed's successful pivot in 1995, and a second round of rate cuts in 1998 provided the fuel for the strongest bull market in history[1]. But they also encouraged speculation that ended with the tech bubble popping in 2000. Four mega-cap tech stocks known as the Four Horsemen (Microsoft, Intel, Cisco, Dell) led the euphoria over internet-related stocks, which expanded to many unprofitable dot-com companies that saw meteoric gains. The party ended with the Fed hiking rates in 1999 and 2000 to cool the economy and prevent inflationary pressures from building.

- **Now:** The narrow market leadership over the past 12 months captures investors' enthusiasm around an elite group of mega-cap tech stocks known as the

Magnificent 7 (NVIDIA, Microsoft, Alphabet, Amazon, Meta, Apple, Tesla) that are enablers of AI. This group of companies accounted for the bulk of last year's market gains and currently trades at an elevated forward price-to-earnings (P/E) ratio of 31. But that is still much lower than the nosebleed valuations of the Four Horsemen in 1999, which had an average P/E of 85[1]. And unlike the late '90s, the outsized gains last year in mega-cap tech have been supported by strong earnings delivery in both absolute terms and relative to the rest of the market.

In our view, the recent broadening of the market gains, with the equal-weight S&P 500 outperforming its market-cap peer, and with value-style investments outperforming growth over the past month, is a sign that the bull market is not exhausted. We think conditions are more like the 1995-1998 period rather than the 1999-2000. The average stock in the S&P 500 trades at a reasonable 16.7 P/E, with more stocks and sectors participating in the rally. To that point, 10 of the 11 S&P 500 sectors are higher over the past three months. For comparison, three months before the burst of the tech bubble, seven of the 11 sectors were lower[1].



Source: FactSet, Edward Jones

Chart description

If not a bubble yet, what can derail the rally?

As laid out above, despite the strong gains over the past five months, we see less of an imminent risk of a broad market bubble. One thing worth noting is that leading up to the 2000 market peak, S&P 500 returns exceeded 20% for five consecutive years between 1995 and 1999[1]. However, a credible risk that could disrupt the market calm would be any further bumps in the inflation outlook, which would force the Fed to either push back or pull completely the expected Fed rate cuts for this year.

Unlike the mid-'90s period where inflation was threatening to rise but stayed in check throughout both the Fed tightening and easing phase, this time the Fed will be sensitive to any disappointments given the inflation spike over the past three years. Consumer and producer prices in January and February surprised to the upside. While the downtrend in core inflation remains intact, a third upside surprise might trigger the Fed to reconsider its approach. For our base-case scenario, we expect the "last mile" of inflation to take longer and require some patience, but we see further progress ahead. Supporting factors may include a moderation in shelter and used car prices, as well as a broader cooling in services inflation driven by slower wage growth.

Opportunities in today's market

- Given the uninterrupted nature of the stock-market rally since last November, a pullback and consolidation phase should be expected. But the combination of resilient economic growth, a reacceleration in corporate profits, and the upcoming start of a rate-cutting cycle at a time when financial conditions are already easy is likely to help sustain the expansion and bull market. We expect this environment to be supportive for both stocks and bonds, but, in our view, the greater opportunity lies within equities, particularly in areas of the U.S. market that have lagged and carry lower valuations.
- More specifically, mid-cap stocks look particularly interesting. Historically, they've been among the strongest-performing asset classes 12-18 months following the last Federal Reserve rate hike, but they've lagged since the Fed's last hike in July of last year. Mid-caps tend to be more cyclical than U.S. large-cap stocks but higher quality than small-cap stocks. Thus, we believe mid-caps may provide portfolios a good balance in the coming months, particularly as investors' confidence about the economic outlook increases, helping to release the catch-up potential of the asset class.
- On the international front, while some of the uncertainty around China has likely already been priced in, we believe the country's underwhelming policy support amid

slowing growth, as well as a challenging regulatory landscape, will continue to weigh on relative performance. We recommend underweighting emerging-market equities, staying neutral with international developed equities, and overweighing U.S. large-cap stocks.

- Within fixed income we favor emerging-market debt over U.S. high-yield bonds. Emerging-market debt has higher interest-rate sensitivity and historically outperforms U.S. bonds in periods following peak Fed policy.

		Underweight	Neutral	Overweight	Our Take
Equity		·	·	●	While economic growth may slow in the near term, we expect it to firm up as inflation cools further and major central banks pivot lower, benefiting equities more than fixed income.
Equity Asset Classes	U.S. large-cap stocks	·	·	●	We favor U.S. large-cap over emerging-market equity, despite elevated valuations, given its relative quality, stronger earnings growth potential and momentum, particularly as the Federal Reserve pivots lower.
	Int'l large-cap stocks	·	●	·	Valuations and dividend yields appear attractive when compared to U.S. equity, but the asset class faces weaker economic and earnings growth prospects, which suggest a more balanced approach for now.
	U.S. mid-cap stocks	·	·	●	U.S. mid-cap stocks are likely to benefit from the relative strength of the U.S. economy and help balance quality with catch-up potential within equities, offsetting the fixed-income underweight.
	U.S. small-cap stocks	·	●	·	While the cyclical nature of U.S. small-cap stocks may benefit from the relative strength of the U.S. economy, we prefer the higher quality of U.S. mid-cap stocks in this environment.
	Int'l small- and mid-cap stocks	·	●	·	Valuations and dividends appear attractive when compared to U.S. equity, but weaker economic and earnings growth prospects may weigh on this more cyclical international equity asset class, suggesting a balanced approach.
	Emerging-market equity	●	·	·	While valuations appear historically cheap, the asset class faces policy and regulatory uncertainty in China, amid slowing growth. We recommend slightly reallocating toward U.S. large-cap stocks for now.
Fixed Income		●	·	·	While economic growth may slow in the near term, we expect it to firm up as inflation cools further and major central banks pivot lower, benefiting equities more than fixed income.
Fixed Income Asset Classes	U.S. investment-grade bonds	●	·	·	Interest rates are likely to drift downward as inflation falls and the Federal Reserve pivots lower, benefiting high-quality bonds, but we expect stocks to outperform. Therefore, we favor a shift toward U.S. mid-cap stocks.
	U.S. high-yield bonds	●	·	·	U.S. high-yield bonds, which generally has lower interest rate sensitivity, historically underperforms emerging-market debt in periods following peak monetary policy. Credit spreads are also relatively low.
	International bonds	·	●	·	Valuations within higher-quality international bonds appear more attractive than U.S. investment-grade bonds, suggesting a more balanced approach to this fixed-income asset class for now.
	Emerging-market debt	·	·	●	Emerging-market debt, which generally has higher interest rate sensitivity, historically outperforms U.S. high-yield bonds in periods following peak monetary policy. Relative valuations are also historically attractive.
	Cash	·	●	·	Cash can provide stability to well-diversified portfolios. But we believe higher interest rates from other bonds can enhance returns and potentially provide greater diversification benefits.

Source: Edward Jones.

Chart description

To wrap up, we think that the mid-'90s analogue is very relevant to today's investment backdrop and offers reasons for optimism, but, of course, it remains to be seen whether the Goldilocks scenario will play out this time. Investors will be rooting for a repeat of the soft landing from 30 years ago but may want to avoid Buzz Lightyear's famous catchphrase in Toy Story: "To infinity and beyond!"

Angelo Kourkafas, CFA
Investment Strategist

Sources: 1. Bloomberg, Edward Jones, 2. Historyofinformation.com

Weekly market stats

INDEX	CLOSE	WEEK	YTD
Dow Jones Industrial Average	39,807	0.8%	5.6%
S&P 500 Index	5,254	0.4%	10.2%
NASDAQ	16,379	-0.3%	9.1%
MSCI EAFE*		0.2%	5.3%
10-yr Treasury Yield	4.20%	0.0%	0.3%
Oil ($/bbl)	$83.00	2.9%	15.8%
Bonds	$97.93	0.1%	-0.6%

*Source: FactSet, 3/28/2024. Bonds represented by the iShares Core U.S. Aggregate Bond ETF. Past performance does not guarantee future results. *4-day performance ending on Thursday.*

The week ahead

Important economic releases this week include the March nonfarm payrolls report and ISM manufacturing PMI.

Review last week's weekly market update.

Angelo Kourkafas

Angelo Kourkafas is responsible for analyzing market conditions, assessing economic trends and developing portfolio strategies and recommendations that help investors work 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.

Read Full Bio

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Important Information:

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