Weekly market wrap

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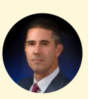

Craig Fehr

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‹ Weekly market wrap

Key Takeaways:

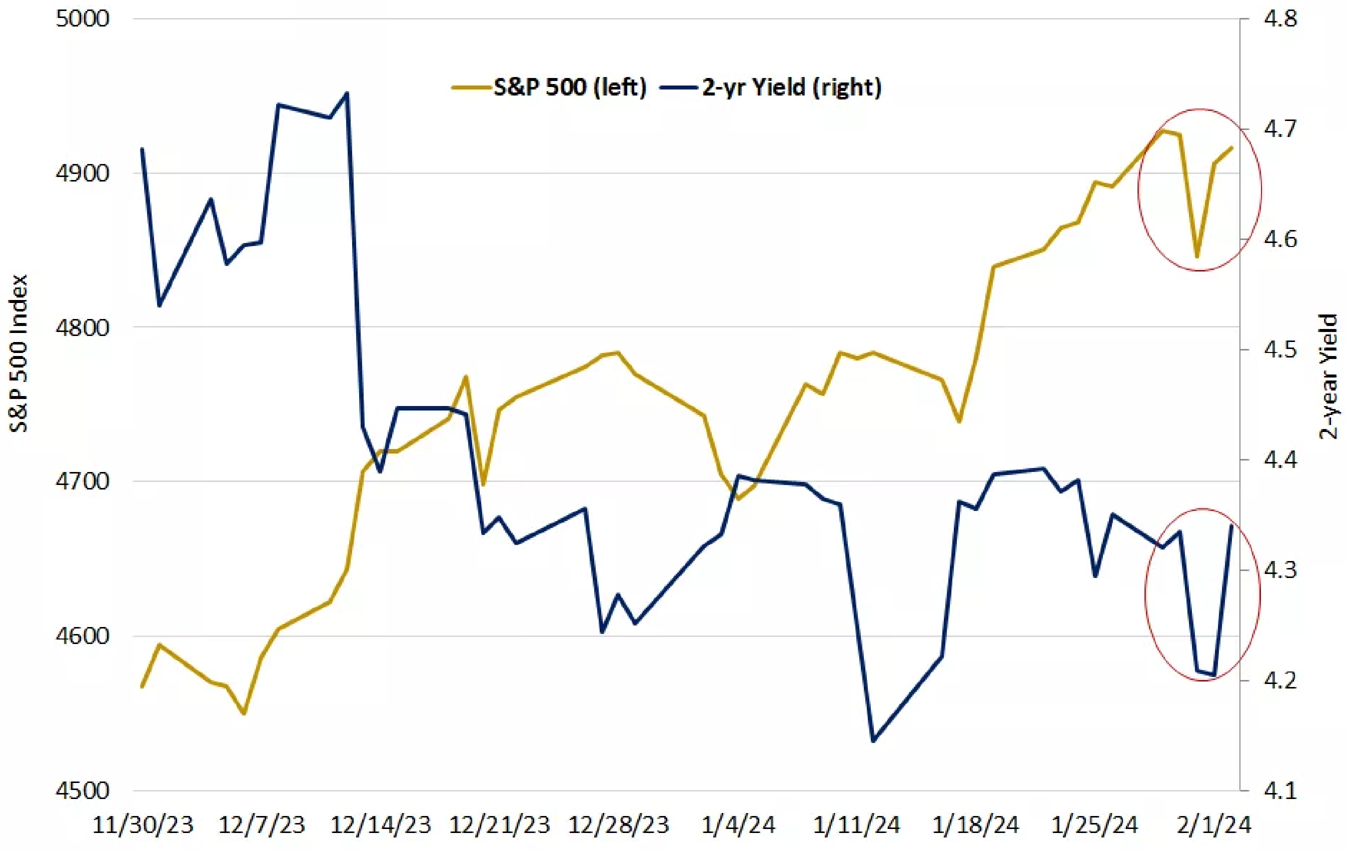
- All eyes were on the Fed last week, with the market's wagon remaining tightly hitched to the outlook for future monetary-policy moves. The Fed kept its policy rate steady, but the primary focus was on the central bank's message that it intends to remain on hold a while longer.
- While markets were hoping for a signal that rate cuts were coming sooner, incoming data, including the latest jobs report, continue to offer confidence that the economy is holding up well enough for the Fed to exercise some patience.
- Stocks have rallied sharply of late, with the S&P 500 gaining 20% in the last three months. Directionally, we think the market has this right, with the recent rally powered by expectations for the Fed to pivot toward looser monetary policy, which has historically been a tailwind for market returns. That said, while we don't think the market is set up for a dramatic downturn, but we do think investors would be well-served to anticipate a few bumps as we advance.

Cue the memes of Jerome Powell in blue face paint as Braveheart's William Wallace. Markets zeroed in last week on the latest Federal Reserve (Fed) meeting, the outcome of which felt very similar to that movie's famous scene in which Wallace implores his soldiers to "HOLD!" as the opposing army rushes toward them on horseback. The purpose was not to react too early and prematurely reveal their defenses, while also ensuring they acted just early enough to effectively fend off the attack.

Powell delivered the same message, telling the market that the Fed will hold (rates steady) as long as possible in order to see the whites of quelled inflation's eyes, while signaling it intends to act (cut rates) in time to fend off a recession. This window is not too small to fit through, in our opinion, but threading the needle of declining inflation and a simultaneously rising economy will not be seamless, nor is it assured.

Encouragingly, markets didn't overreact, with the S&P 500 see-sawing its way to a gain on the week, hitting an all-time high. We'd attribute this to a continued influx of data showing that the economy remains in good shape, bolstering the case for Fed patience and the market's willingness to give monetary policymakers the benefit of the doubt. Here are three takes from last week that we think investors can hold on to:

> **Stocks and interest rates swung widely last week, as markets digested the Fed and employment news, but finished the week little changed.**



Source: Bloomberg. S&P 500 index and 2-year U.S. Treasury yield.

Chart description

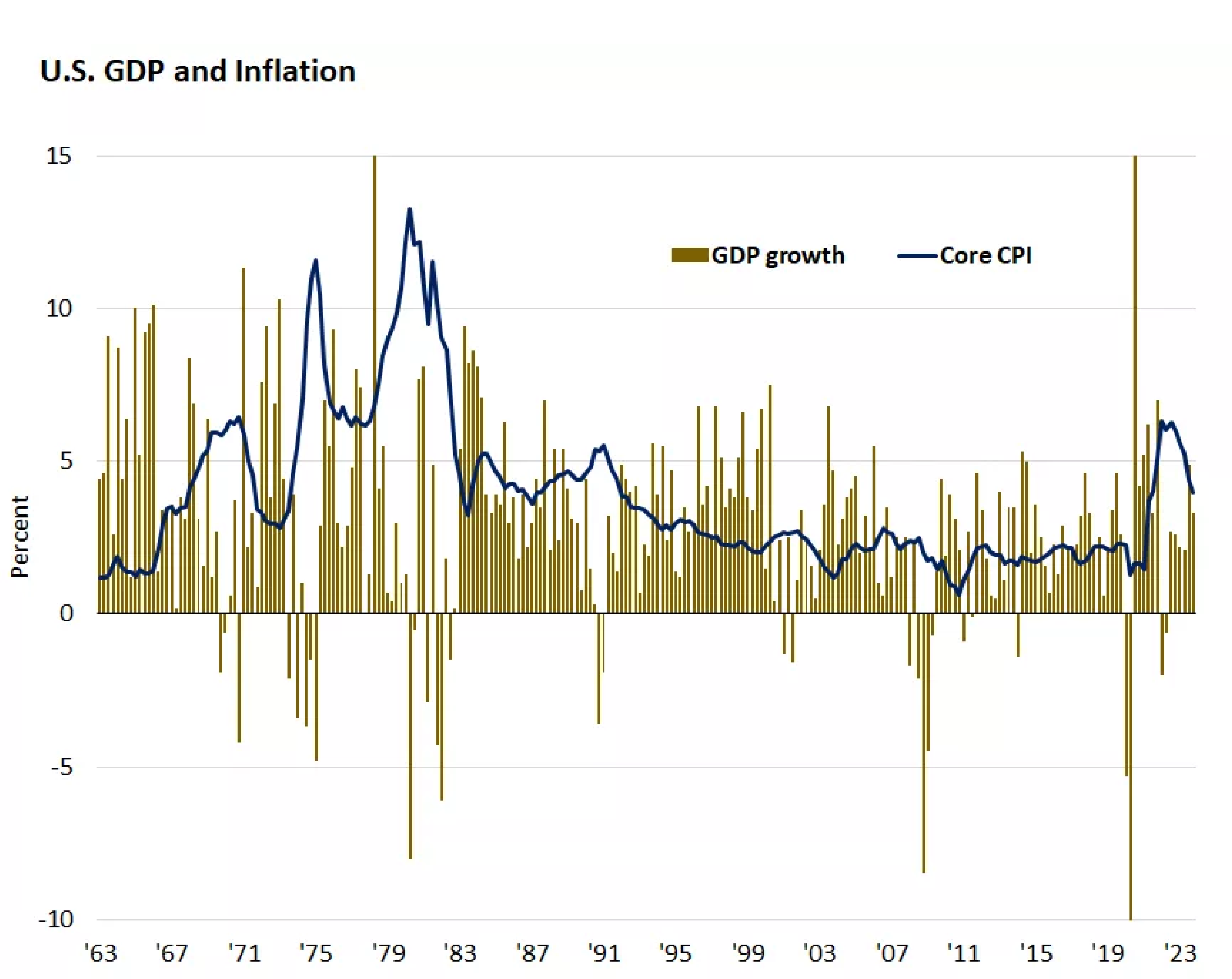
1. The Fed stays on hold, but cuts are a question of when, not if.

- As expected, the Fed kept its policy rate unchanged last week. The market's focus was centered squarely on future meetings, seeking any signals around when a rate cut may come. Markets have been pricing in a cut as early as March, an expectation we have firmly disagreed with.
- The Fed didn't give the market what it was hoping for, instead emphasizing that it plans to wait a while longer in order to build greater confidence that inflation will remain on its current, descending path.
- This was the right move, in our opinion. Cutting prematurely runs the risk of having to backtrack if inflation were to perk back up, an outcome that would be far more detrimental to the markets than staying on hold a little longer. To be clear, overstaying its welcome with restrictive policy also brings the risk of undermining economic growth, so the Fed does not have an extreme amount of flexibility here. But we've seen the former movie before, with the Fed declaring victory too early in

the 1970s, which sowed the seeds of the inflation spike that produced a rather severe recession in 1980-1982.

- The upshot for investors: Monetary-policy settings are set to get less restrictive this year, and that's good news for the economy and the stock and bond markets. The consternation really revolves around timing. We think the first rate cut probably won't come until June, at the earliest, but we do think it's coming. The Fed is faced with a tricky dance, and we would be surprised if a toe or two doesn't get stepped on. But in the end, when it comes to the first rate cut, we doubt a matter of a few months will be the sole determining factor in the broader path for the economy and stock market.

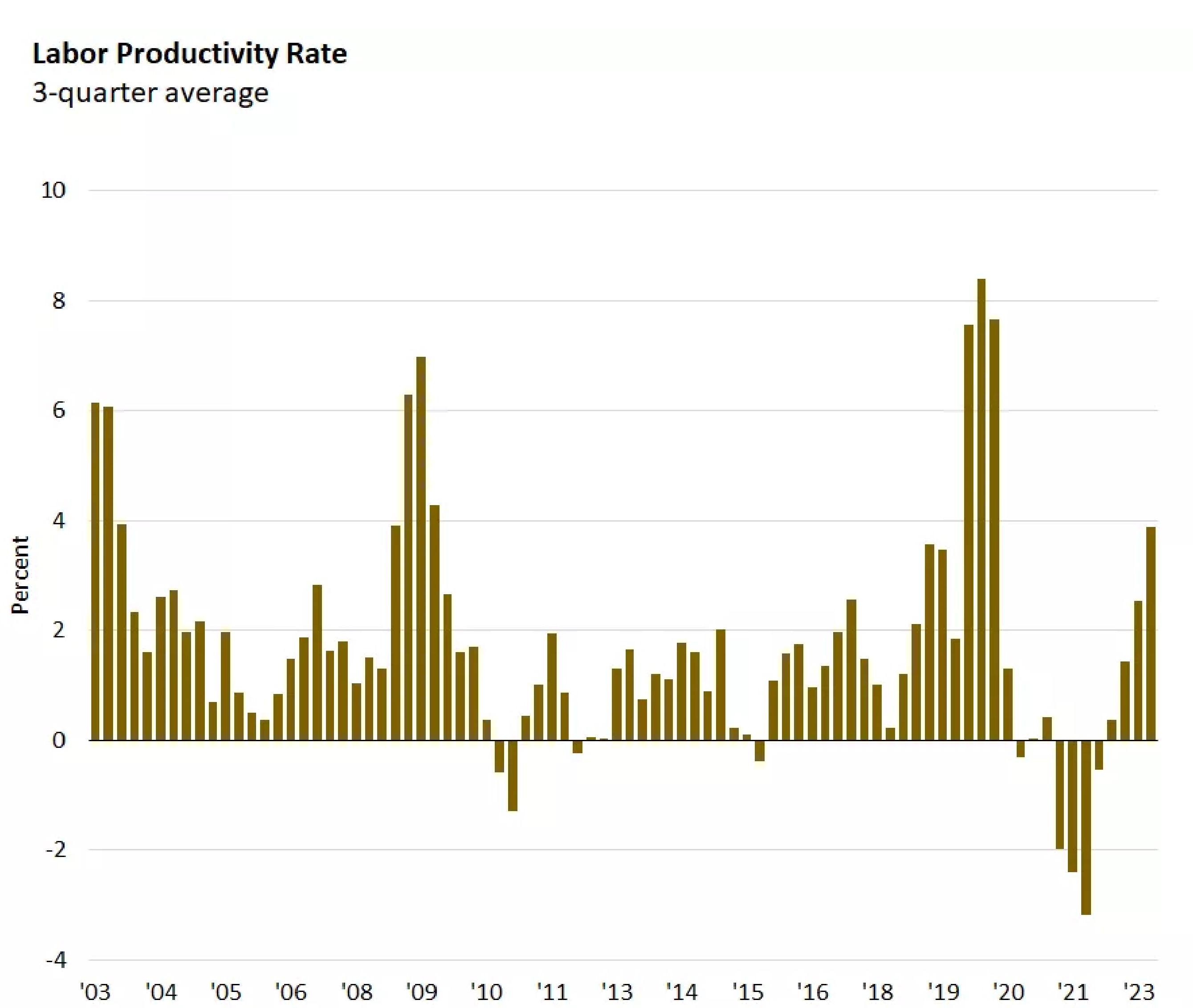
Further declines in inflation will be critical to the Fed's ability to cut rates and support GDP growth.



Source: St. Louis Fed. GDP Q/Q, annualized, Consumer price index excluding food & energy, Y/Y.

Chart description

Rising workforce productivity can enable inflation pressures to moderate even as economic output rises.



Source: FactSet, Edward Jones

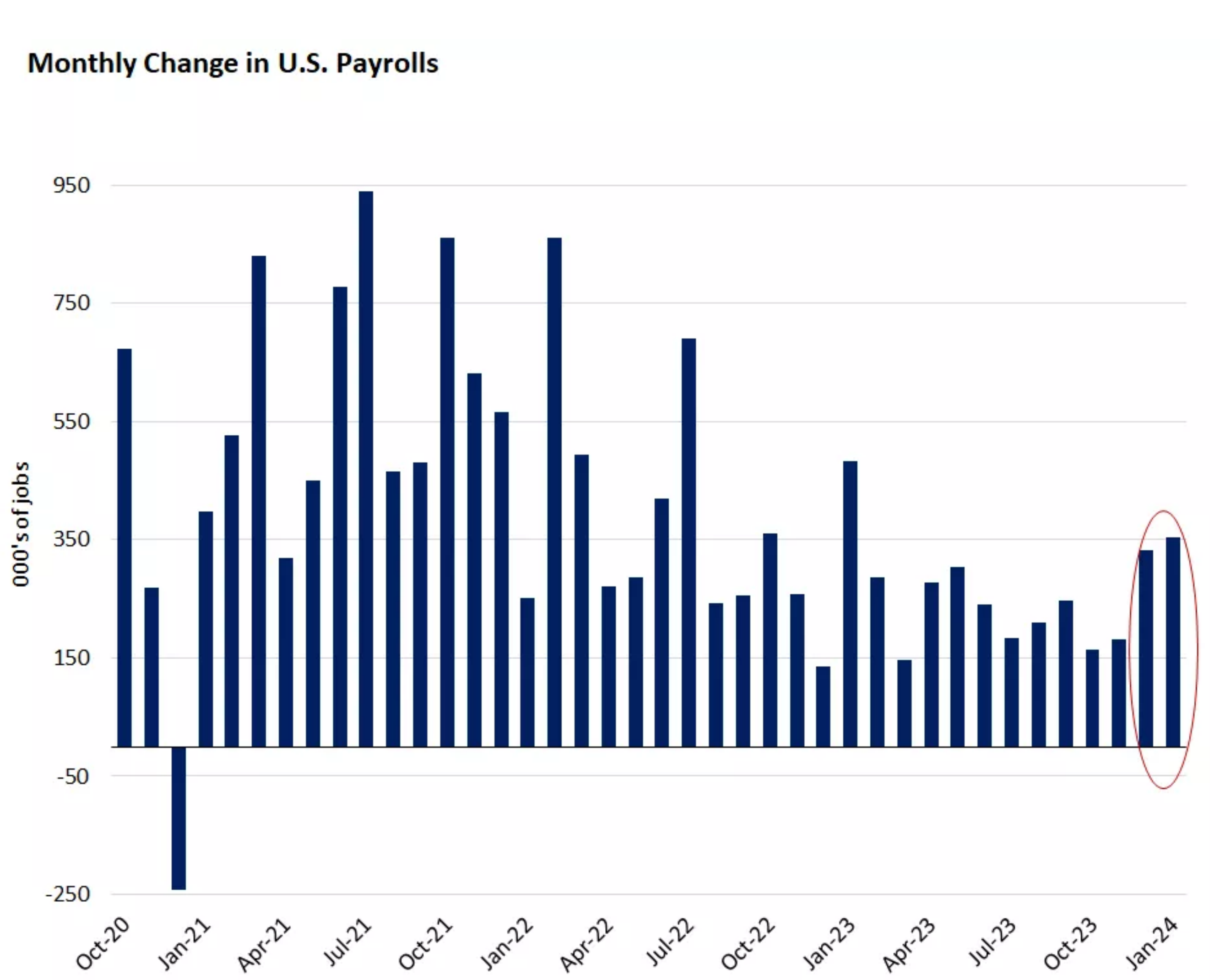
Chart description

2. **The labor market is holding up, which buys the Fed time.**

- While the Fed rate announcement produced no surprises, that wasn't the case for the latest jobs report. The economy added a whopping 353,000 payrolls in January, double the consensus estimate. This was the strongest monthly gain in more than a year and the second straight month above 330,000, which last occurred in the summer of 2022. The unemployment rate held steady at 3.7%, still just a shade above the 50-year low of 3.4%. Despite the outsized hiring

gain, unemployment remained unchanged due to an increase in the labor force.

Firming job gains offer support for ongoing economic resilience.

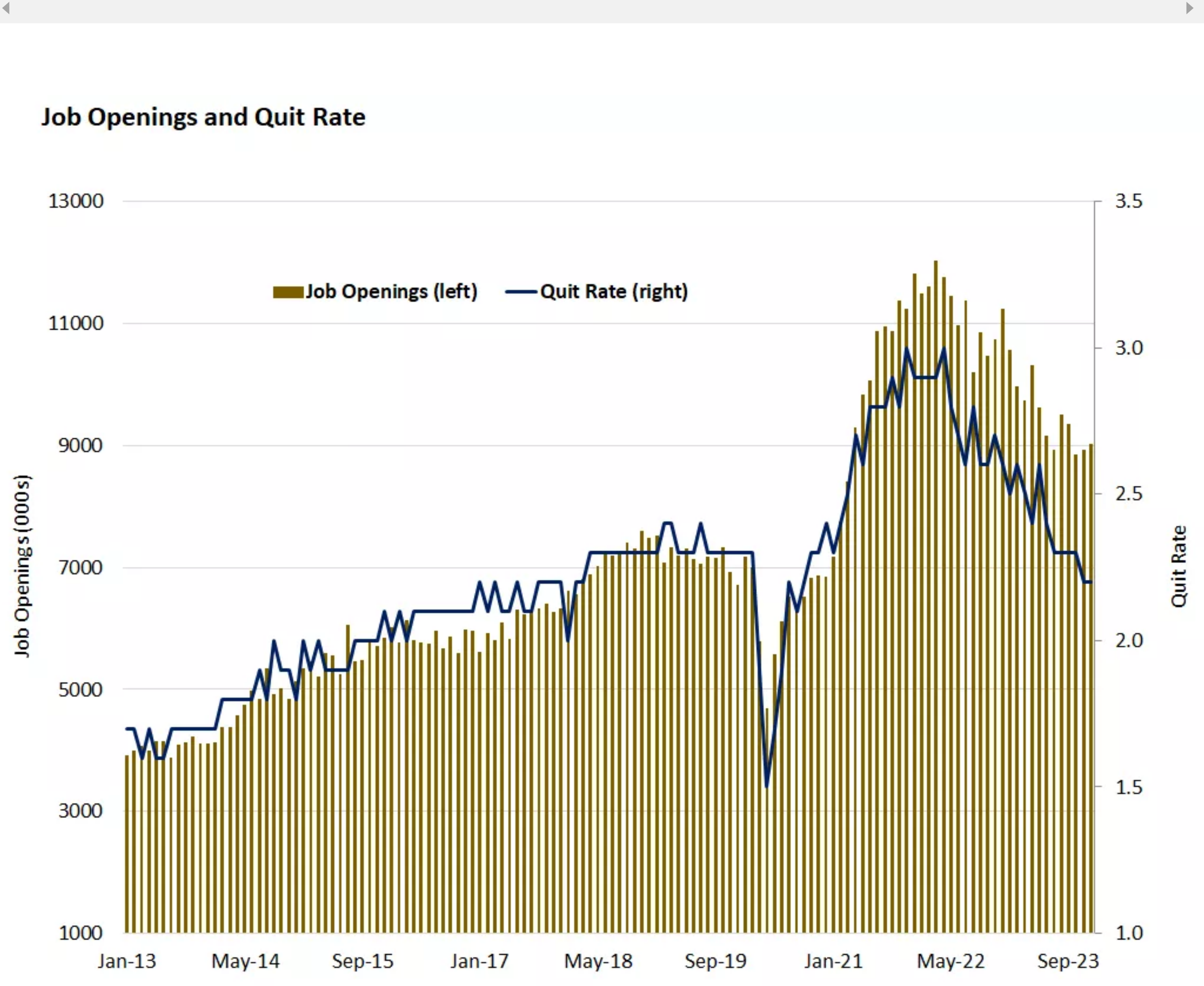


Source: FactSet.

Chart description

- Sustained economic resilience requires a solid labor market, so this was a categorically positive report from the GDP growth standpoint, with the firming of job gains signaling that the economy is not teetering on the edge of exhaustion. At the same time, other reliable measures of the labor market indicate that employment conditions are beginning to soften. Data last week showed that job openings (an indicator of labor demand) and the quit rate (signaling the availability of new jobs and workers' propensity to leave their existing position) are leveling off (having weakened over the last year).

Job openings and quits signal some softening in employment conditions.



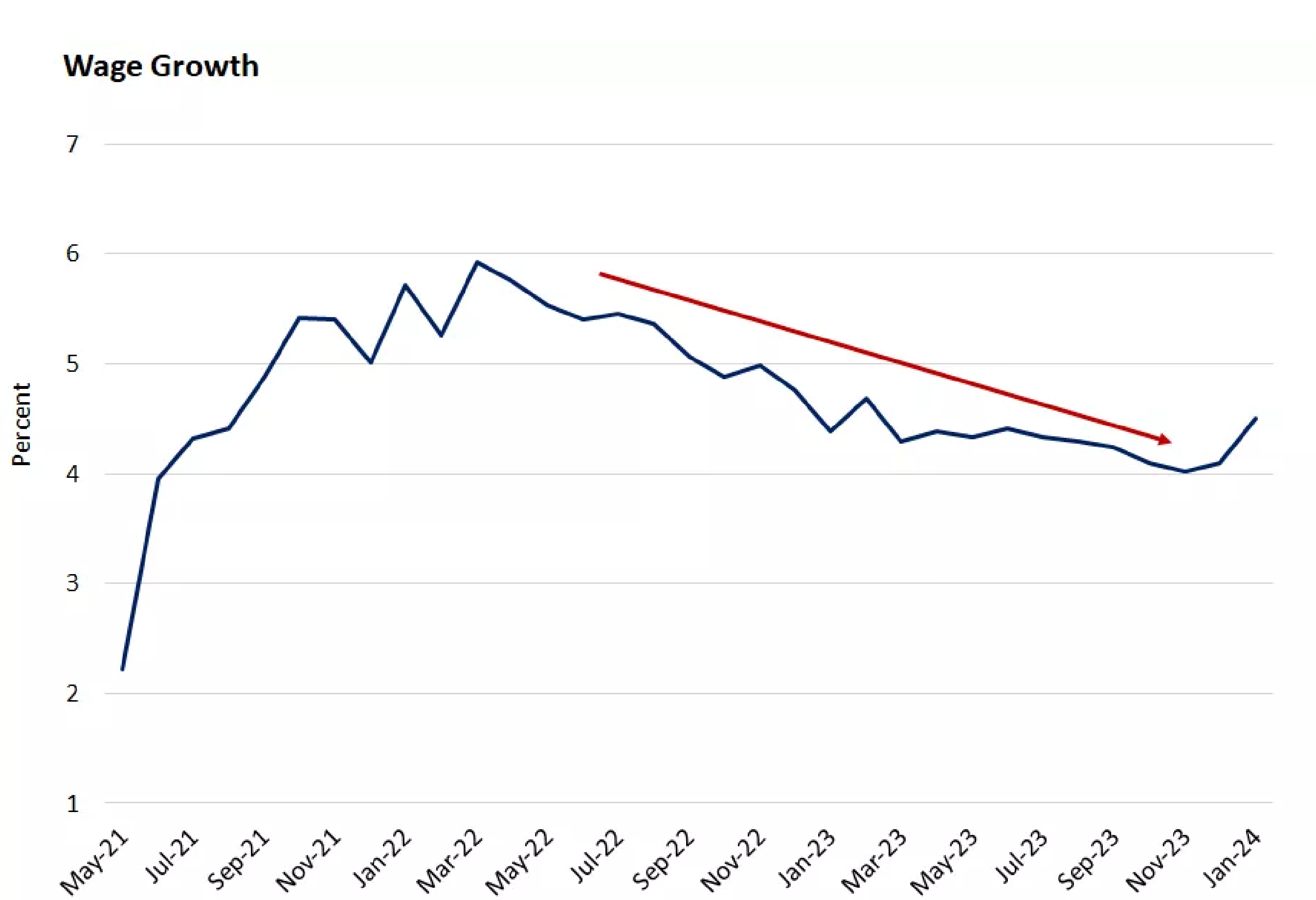
Source: Bureau of Labor Statistics.

Chart description

- We think the healthy state of the labor market is the lynchpin in the outlook for the economy to slow but not fall into a traditional recession. Depleted excess savings and moderating wage growth will give consumers less firepower in 2024 compared with spending activity last year. However, given the low starting point of unemployment and ongoing monthly job growth (despite the recent pickup in layoff announcements), we don't see anything in this recent data that suggests the consumer is headed for hibernation. Our analysis continues to suggest the economy could endure a bit of a growth scare this year, but GDP growth primarily goes as the consumers goes, which supports the case for a more benign slowdown.

- To us, this employment report poses direct implications for the Fed's approach discussed above. The resilience of the labor market should raise confidence that the economy is not in such a fragile condition that holding rates steady for longer threatens a dramatic toppling of GDP growth. Further, a notable figure from January's payroll report was the uptick in wage growth, which increased to 4.5%, the highest since last September. This is helpful to consumer spending, but less so for the falling-inflation narrative. We're careful not to put too much weight on one reading (particularly when it tells a different story than much of the other recent data, including the unit-labor-cost figure released last week, which showed wage pressures have moderated significantly), but we think the combination of strong payroll gains and firm wage growth supports the case for the Fed to wait longer before cutting rates. In our view, this should remove any expectations for a rate cut in March or in May. We think the summer is the most likely point at which the Fed can confidently begin to pencil in the first cut.

Wage growth reaccelerated in January, potentially complicating the Fed's view on inflation.



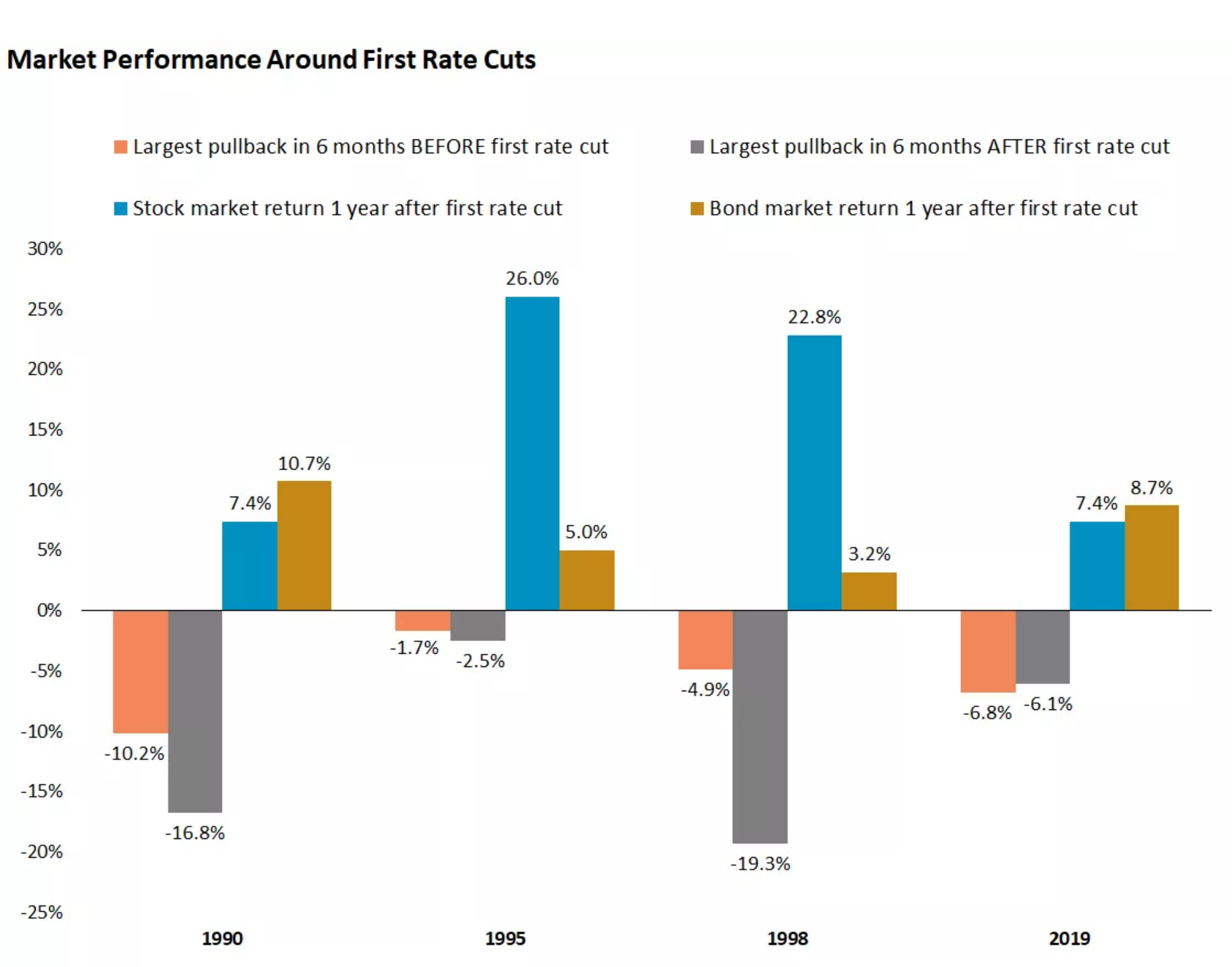
Source: FactSet. Year-over-year percentage change in average hourly earnings.

Chart description

3. In the event of turbulence, hold on.

- While a shift toward less restrictive Fed policy this year is, in our view, broadly favorable for financial markets, it won't come without hiccups. Looking back at initial Fed rate cuts in 1990, 1995, 1998 and 2019 (this excludes the rate cuts in 2000 and 2007 that were accompanied by popping market and housing bubbles, conditions that we don't see as parallels to today), noticeable stock-market pullbacks occurred before and after the rate cut (save for 1995, which didn't experience even one 5% pullback during the year). These spates of market weakness proved to be buying opportunities for both stocks and bonds.

Market pullbacks are common around the initial Fed rate cut, but markets have traditionally done well afterward.



Source: Bloomberg, Edward Jones. Total return for the S&P 500 Index and Bloomberg U.S. Aggregate Bond Index.

Chart description

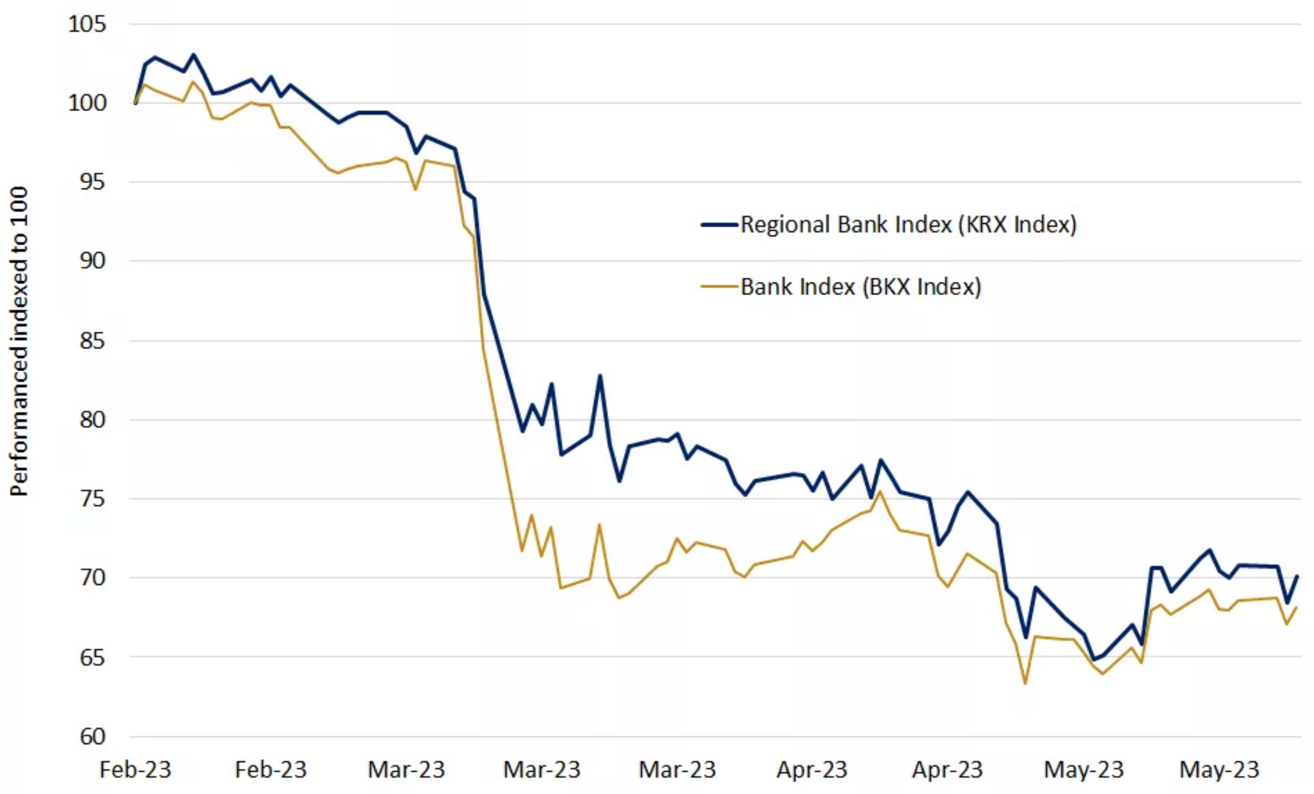
- Stocks have rallied sharply of late, with the S&P 500 gaining 20% in the last three months. Directionally, we think the market has this right, with the recent rally powered by expectations for the Fed to pivot toward looser monetary policy, which has historically been a tailwind for market returns. That said, the market was prone to overreactions over the last year, with pullbacks last February and August-October coming as the market adjusted its expectations.

Disappointments around Fed policy expectations have been a source of temporary market weakness.

Source: Bloomberg, S&P 500 Index.

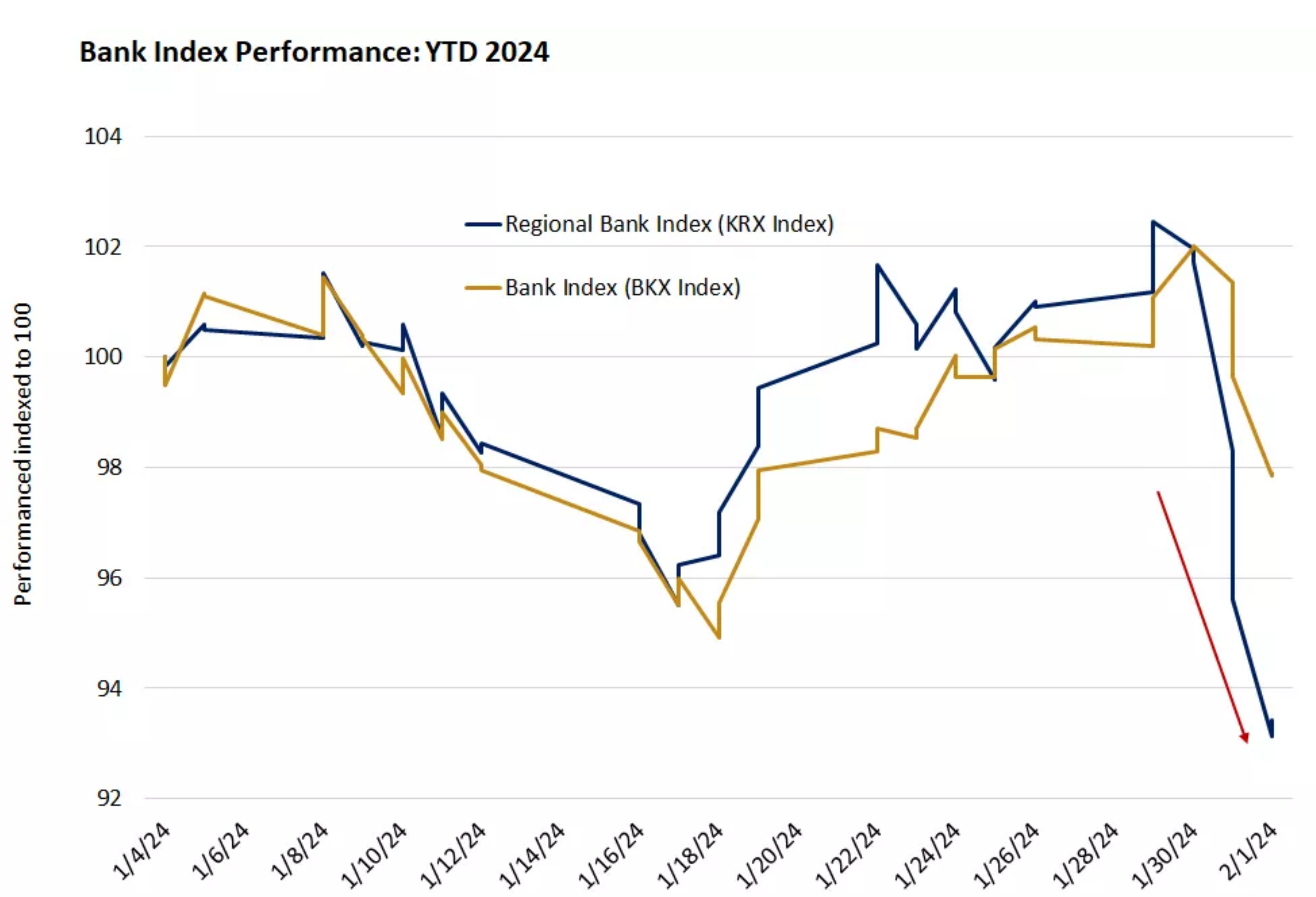
Chart description

- We don't think the market is set up for a dramatic downturn, but we do think investors would be well served to anticipate a few bumps as we advance. We'd highlight that it was particularly encouraging to see that markets didn't use the hotter-than-expected wage-growth number as a catalyst to sell off (under an interpretation that wages will disrupt the inflation trend and keep the Fed in a restrictive stance for longer). We think this was a rational (non)reaction in equities (though bond yields did erase their midweek decline), and, in our view, reflects the wider view that the healthy economy is good for rising corporate profits, which we believe will be the main character in further equity-market gains in 2024.
- On our radar: Last week, worries over the financial health of small banks resurfaced, hearkening back to the bank turmoil that emerged last March when a small number of regional banks (such as Silicon Valley Bank) experienced some unique financial troubles and sparked worries of a spreading banking-system crisis (which did not come to fruition). Last week, shares of a small community bank, New York Community Bancorp (NYCB), fell sharply on news of financial challenges. A cohort of smaller banks underperformed, reflecting some anxiousness around additional challenges. As depicted in the charts below, in the bank crisis last year, bank stocks were broadly under pressure, with smaller banks (represented by the KRX index) and the group including the larger U.S. banks (BKX index) performing similarly during the initial stages of the turmoil. Last week, the reaction was largely centered on a small number of community or regional banks, which we think is a reflection that this is not threatening the broader banking system. While we don't think this will necessarily become a market-moving event, we do think credit conditions and some stress in the commercial real estate market could pose challenges for some smaller banks, a development we will be watching closely.



Source: Bloomberg. Price performance for the KRX and BKX indexes.

Chart description



Source: Bloomberg. Price performance for the KRX and BKX indexes.

Chart description

Craig Fehr, CFA
Investment Strategy

Weekly market stats

INDEX	CLOSE	WEEK	YTD
Dow Jones Industrial Average	38,654	1.4%	2.6%
S&P 500 Index	4,959	1.4%	4.0%
NASDAQ	15,629	1.1%	4.1%
MSCI EAFE*	2,223.18	0.0%	-0.6%
10-yr Treasury Yield	4.02%	-0.1%	0.1%
Oil ($/bbl)	$72.37	-7.2%	1.0%
Bonds	$98.46	0.4%	0.4%

*Source: FactSet, 2/2/2024. Bonds represented by the iShares Core U.S. Aggregate Bond ETF. Past performance does not guarantee future results. *Morningstar Direct 2/4/2024.*

The week ahead

Important economic data being released this week includes the ISM services PMI reading and consumer credit data.

Review last week's weekly market update.

Craig Fehr

Craig Fehr is a principal and the leader of investment strategy for Edward Jones. Craig is responsible for analyzing and interpreting economic trends and market conditions, along with constructing investment strategies and asset allocation guidance designed to help investors reach their financial goals.

He has been featured in *Barron's, The Wall Street Journal*, the *Financial Times, SmartMoney* magazine, *MarketWatch*, the *Financial Post*, Yahoo! Finance, Bloomberg News, Reuters, CNBC and Investment Executive TV.

Craig holds a master's degree in finance from Harvard University, an MBA with an emphasis in economics from Saint Louis University and a graduate certificate in economics from Harvard.

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Special risks are inherent in international investing, including those related to currency fluctuations and foreign political and economic events.

Market Data

DJIA 38,367.96 ↓ (-286.46)

S&P 500 4,944.87 ↓ (-13.74)

NASDAQ 15,599.19 ↓ (-29.77)

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