Weekly market wrap

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‹ Weekly market wrap

A run-of-the-mill correction, or

something worse?

Key takeaways:

- *Stocks entered correction territory, down about 10% from their peak in late July, driven by a renewed rise in long-term government bond yields and mixed earnings reports from mega-cap tech.*
- *Progress on inflation and lessening headwinds provides some confidence that the current pullback will not morph into another bear market. We offer 10 reasons why the recent weakness could prove to be a run-of-the-mill correction, which while uncomfortable, is common.*
- *We recommend to remain opportunistic and consider adding quality investments at lower prices, while maintaining realistic expectations for returns and volatility*

Stocks entered correction territory last week, down about 10% from their peak in late July. A renewed run toward 5% on the 10-year Treasury yield and mixed earnings reports from mega-cap tech were the sparks for the S&P 500 to hit its lowest point in five months[1]. While the "Magnificent Seven" (Amazon, Apple, Alphabet, Meta, Microsoft, NVIDIA and Tesla) have powered the rally since last year's bear-market low, they have also been the ones to drag major indexes lower since mid-October. Is the recent market turbulence part of an uncomfortable but normal correction, or the start of something bigger?

Challenges exist, but the U-shaped recovery scenario remains in play

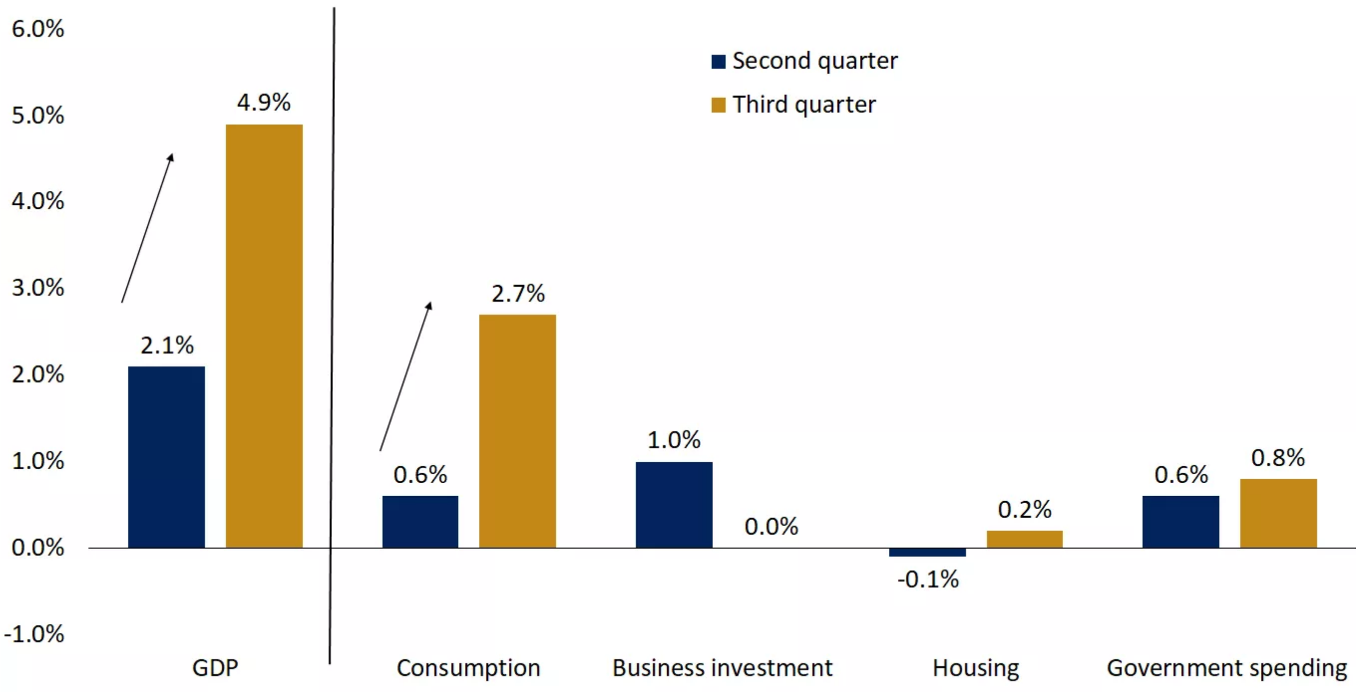
We don't think that the impact of the prior Fed rate hikes has been completely felt by the economy, and therefore the coast is not yet clear. However, the progression of several key fundamental drivers provides some confidence that the current pullback will not morph into another bear market. Late last year we made the case that equities are likely to navigate a U-shaped recovery instead of a V-shaped one, and the price action since then suggests that we should remain on that path.

Without dismissing the risks, we offer 10 reasons why the recent pullback in stocks and bonds may present an opportunity for investors to add quality investments at lower prices ahead of a potential rebound.

1. The economy remains resilient

- According to the government's preliminary estimate, the U.S. economy grew at a 4.9% annual pace in the third quarter, ahead of estimates and more than double the second-quarter pace. The strong growth was driven by consumer spending, which remains the economy's workhorse. Government spending aided growth for the fifth straight quarter, while housing rebounded, posting its first quarterly increase in more than two years[1].
- We don't think that the economy can continue growing at the same pace, and, in fact, we think that it is likely that we may go through a soft patch in the coming quarters. High borrowing costs will soon have an impact on the consumer, and spending is unlikely to keep growing faster than disposable income, now that excess savings are mostly depleted. Yet, we don't think that growth will fall off a cliff either. A still-strong labor market and solid consumer finances relative to history will support consumer spending for a while longer.

U.S. consumers power strong growth in the face of Fed tightening
Contributions to Q3 GDP growth



Source: FactSet, Edward Jones.

Chart description

2. Inflation continues to moderate

- Despite stronger-than-expected growth and low unemployment, inflation remai on a downward path. The core personal consumption expenditures (PCE) price index, which is the Fed's preferred measure of inflation, ticked down to 3.7% in September from 3.8% in the prior month. That is still way above the Fed's 2% target but significantly below last year's 5.6% peak[1]. We think that the deceleration in wage growth and lower housing inflation will drive further improvement in the quarters ahead.

3. The Fed is preparing to end its rate hikes

- At this week's meeting the Fed is expected to keep interest rates unchanged, as the recent surge in long-term bond yields is helping convince policymakers that there is less need for further hikes. While the Fed will likely keep all options open, it is possible that the July hike might have been the last of this tightening cycle. Historically, a Fed pause has been positive for markets, with stocks rising strongly in five instances between the last hike and the first cut, while declining only modestly in two cases (1987 and 2001). Bonds achieved above-average returns in six of the seven instances[2].

Last hike	First cut	Months from last hike to first cut	S&P 500 return	Investment grade bonds return
08/1984	10/1984	1	11%	4%
09/1987	10/1987	1	-2%	-2%
02/1989	06/1989	3	11%	7%
02/1995	07/1995	5	19%	10%
05/2000	01/2001	8	-7%	11%
06/2006	09/2007	15	25%	10%
12/2018	07/2019	7	18%	7%

Source: FactSet, Edward Jones.

Chart description

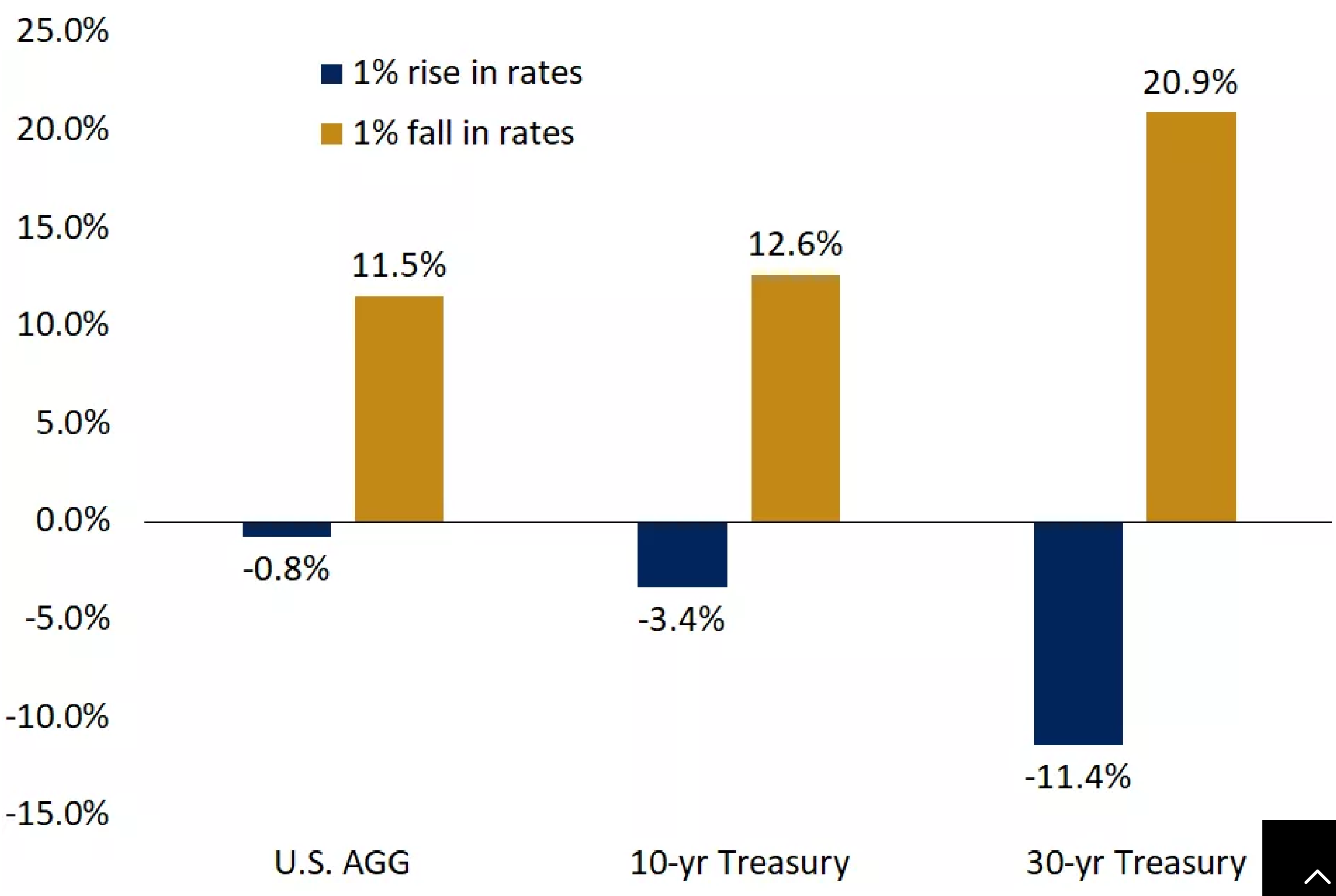
4. Bond yields are potentially peaking

- The surge in the 10-year Treasury yield to 5%, a 16-year high, has pressured bot equity valuations and bond prices[1]. While the exact time is hard to pinpoint, we think that yields might be approaching a cyclical peak as economic growth slows, the Fed pivots to rate cuts in 2024, and inflation gets closer to the Fed's 2% target.

5. Valuations have improved

- The recent pullback in stocks has brought the S&P 500 price-to-earnings ratio (based on next 12-month earnings estimates) down to 17.4 from 19[1]. While on the surface valuations are not cheap relative to current bond yields, many segments of the equity market trade at deeper discounts. For example, the S&P 500 Equal Weighted Index trades at 14 times earnings, and value style-investments, as proxied by the Russell 1000 Value index, trade at 13 times earnings, vs. the "Magnificent Seven" at 30 times[1].
- In fixed income, the upside of the historic decline in bonds is that yields are now attractive and therefore are likely to produce high returns. The larger income component can better offset price declines, and because of that, a 1% decline in rates would potentially translate to a much larger upside in prices than the downside from an equivalent 1% rise in rates[2].

Upside vs. downside in bonds appears favorable



Source: FactSet, Edward Jones.

Chart description

6. Earnings are rebounding

- After three consecutive negative quarters, corporate profits are on track to return to growth in the third quarter and are expected to improve further through 2024. Solid demand is driving a reacceleration in revenue growth, while the decline in material and input costs is likely to help profitability rebound. We think that analyst estimates calling for 12% growth next year might prove overly optimistic[2]. Nonetheless, in contrast to last year when profits declined, rising earnings will likely support rising stock prices.

7. Signs that the worst in manufacturing activity is over

- Manufacturing activity has been in contraction for most of the past year. But the S&P Global PMI survey released last week returned to expansion territory in October and appears to be curving out of a bottom[1]. While manufacturing is a much smaller part of the economy relative to services, it is an important signal, as it tends to indicate potential inflection points in the economy.

8. Increase in oil prices remains contained

- Heightened geopolitical uncertainty briefly pushed WTI oil above $90 a barrel on fears that supply might be disrupted. However, prices have now subsided slightly below last year's, meaning that energy will be a neutral to slightly negative influence on the October inflation reading[2].

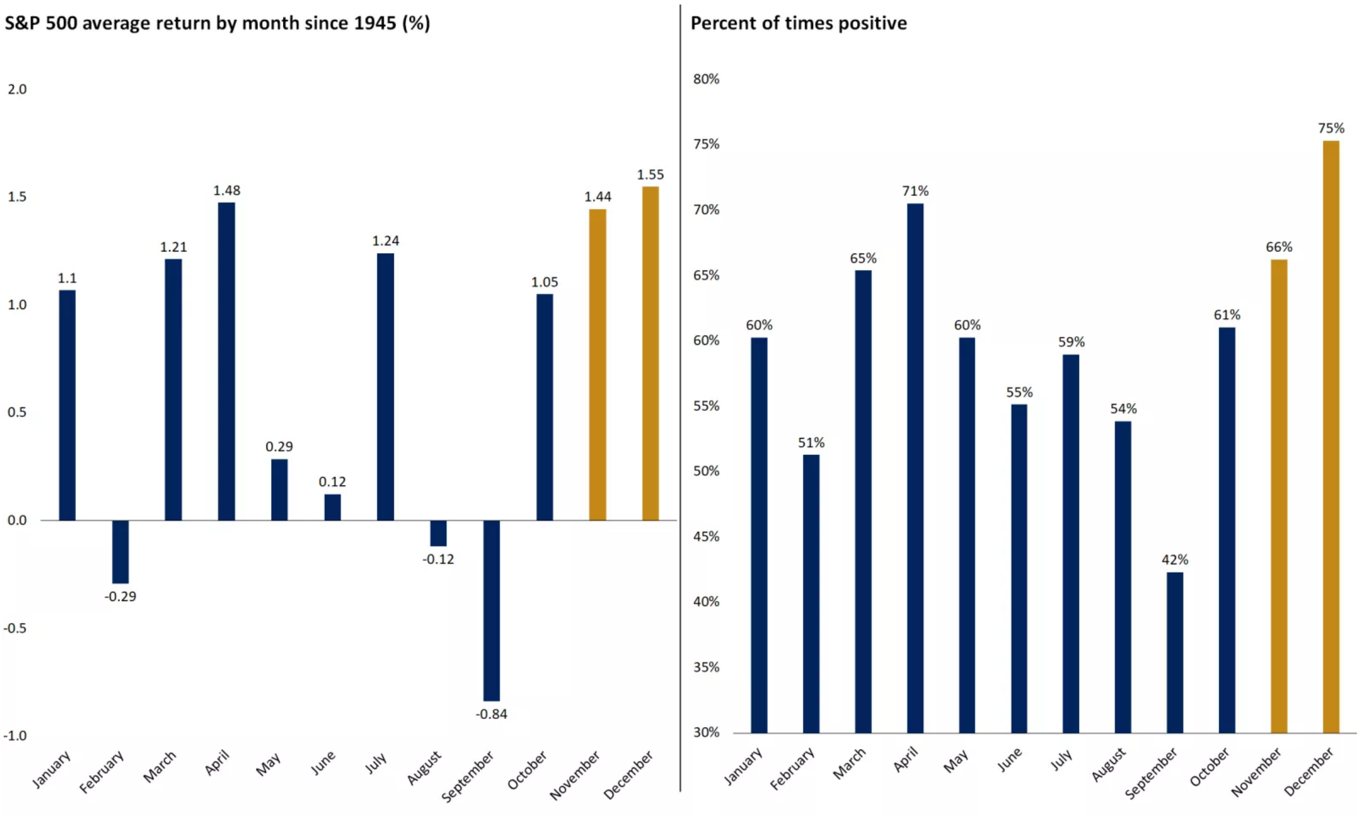
9. There is less investor complacency

- While sentiment among investors was very positive and in cases euphoric during the summer months amid enthusiasm around AI and stronger growth, the mood has turned darker as of late. These swing in emotions are reflected in the AAII Investor Sentiment Survey, which was showing a bulls-to-bears ratio of 2 in July vs. a 0.68 ratio currently[1]. Sentiment tends to be a contrarian indicator, as complacency usually leads market corrections, while skepticism provides the fuel for equities to climb the proverbial wall of worry.

10. Seasonal factors turn positive in November and December

- Fundamental conditions drive market returns, not the calendar. But history shows that there are some seasonal patterns to returns that can be observed over time.

Since 1945, November and December tend to be good months for stocks, with the S&P 500 achieving above-average gains and the highest chances of positive returns[2].



Source: Morningstar Direct, Edward Jones.

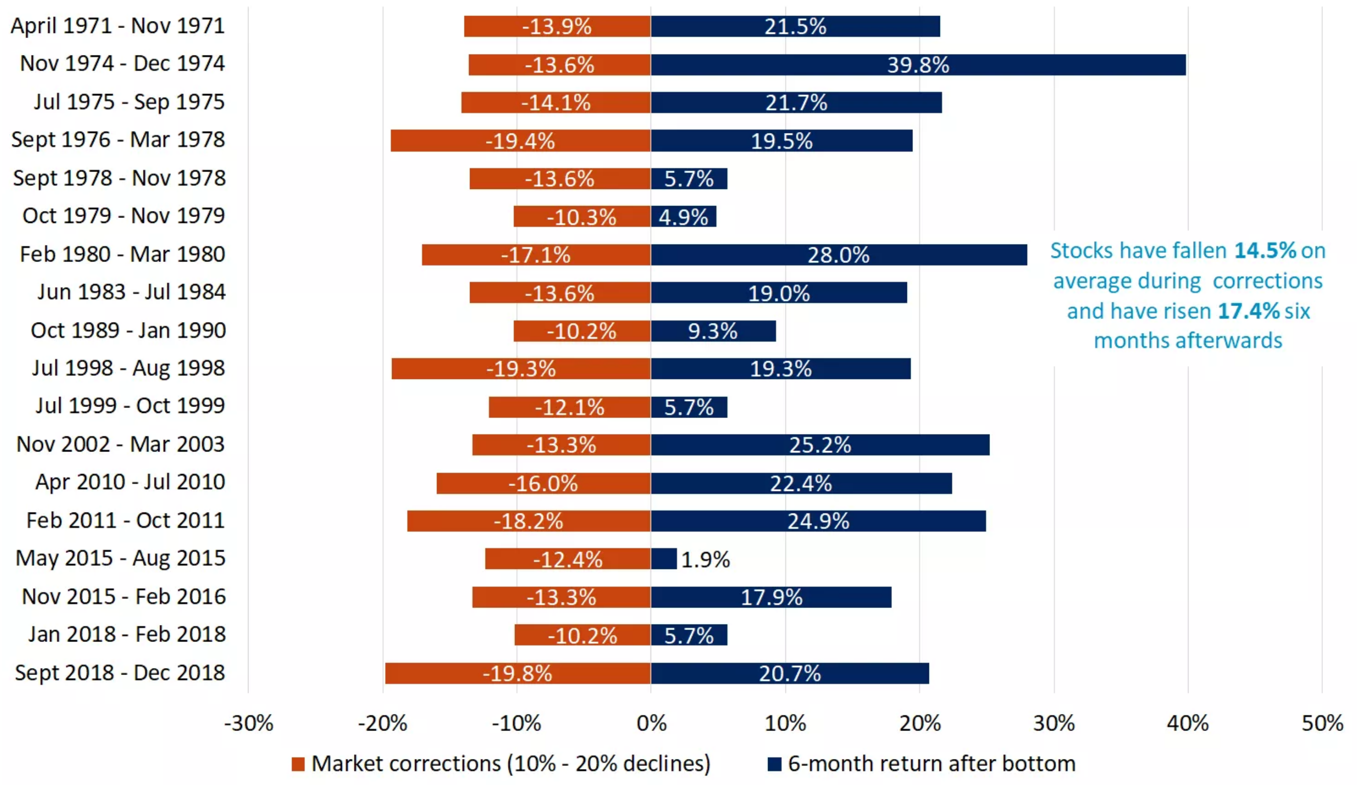
Chart description

Historical perspective on corrections

Corrections like the one equity markets are experiencing this month are uncomfortable, yet common. Since 1971 there have been 18 corrections that did not progress into a bear market, with an average decline of 14.5% from peak to bottom over an average of 4.3 months. Historically, these sizable market pullbacks that took place within the confines of a bull market have been good times to add equities, with stocks rising 17% six months after and 23% a year later[2].

The trigger for past corrections has varied, ranging from tight Fed policy, economic dissapointments, geopolitical uncertainties, the recalibration of lofty expectations, or a combination of these, which is the case this time. Yet, the S&P 500 has been able to recoup its losses in about four months from the time stocks bottomed[2].

S&P 500 returns during and after corrections



Source: FactSet, Edward Jones.

Chart description

A bump in the road, not a repeat of 2022

- An eventual slowdown in economic growth, the gradual cooling in the labor market, and heightened geopolitical uncertainties are likely to keep volatility elevated for longer. Because the Fed wants to ensure inflation returns to target, it will keep policy restrictive for some time, and the market recovery may not be as swift.
- However, the progress on inflation and the lessening headwinds suggest to us that we have moved further away from the worst-case scenarios. The S&P 500 has spent 455 days without making a new high, the longest since the Global Financial Crisis, and is about 14% away from its January 2022 peak, implying a heathy return even if it takes a while to get there[1]. Beyond the increasingly concentrated S&P 500, valuations for many parts of the equity market are below historical averages.
- We recommend to remain opportunistic and consider adding quality investments at lower prices, while maintaining realistic expectations for returns and volatility. A focus on balance and diversification can potentially better help weather short-term dips, which, over the long term, are nearly impossible to avoid.

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Source: 1. Bloomberg, 2. FactSet, Edward Jones

Weekly market stats

INDEX	CLOSE	WEEK	YTD
Dow Jones Industrial Average	32,418	-2.1%	-2.2%
S&P 500 Index	4,117	-2.5%	7.2%
NASDAQ	12,643	-2.6%	20.8%
MSCI EAFE*	1,943	-0.9%	-0.1%
10-yr Treasury Yield	4.83%	-0.1%	1.0%
Oil ($/bbl)	$85.21	-3.3%	6.2%
Bonds	$92.57	0.6%	-2.2%

Source: FactSet, 10/27/2023. 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 data being released this week includes the FOMC meeting and labor market data.

Review last week's weekly market update.

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Market Data

DJIA 32,417.59 ↓(-366.71)

S&P 500 4,117.37 (0.00)

NASDAQ 12,643.01 (0.00)