Weekly market wrap

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Paving the way for a pivot

Key takeaways:

- *The Fed's next move will likely be a rate cut instead of a hike, but the timing of when that might happen could be a source of volatility.*
- *The labor market remains strong but is gradually loosening, which, together with better inflation trends, supports a pivot to less restrictive central-bank policy in 2024.*
- *Our base-case scenario calls for three to four rate cuts in the back half of 2024, which should help bonds recover.*
- *Interest-rate stability could be the catalyst for a rotation from this year's equity winners to the laggards. We think the narrow market leadership and wide valuation gaps have created an opportunity in areas of the market that have been left behind.*

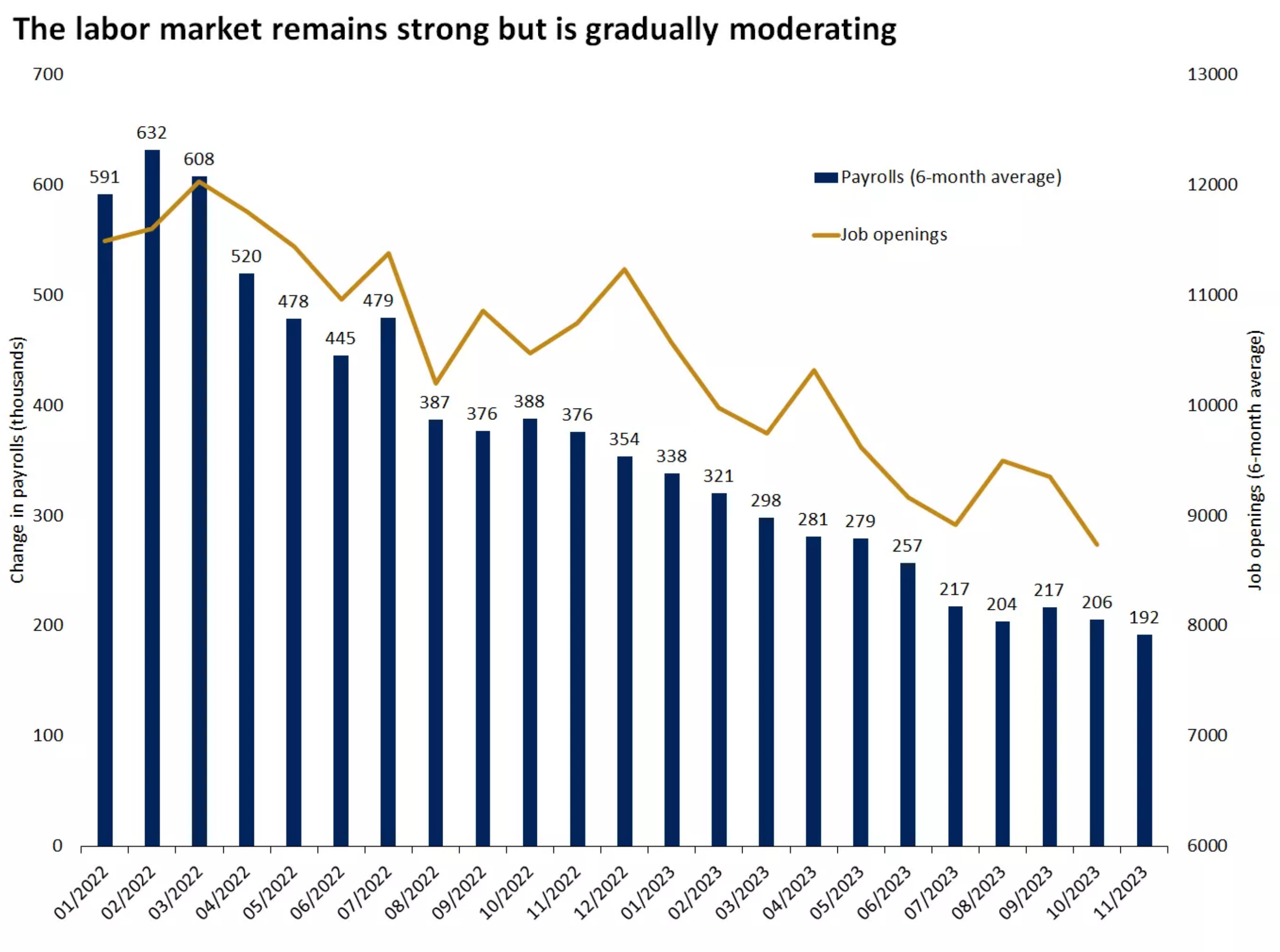
With a few weeks left till the end of 2023, markets remain on track for a strong finish. Stocks are hovering near their highs for the year, and bonds are rebounding nicely after a tough three-year stretch. The overarching forces supporting balanced portfolio gains this year have been the easing in inflation pressures, a resilient economy that has not only avoided a recession but has grown at an above-average pace, and enthusiasm around artificial intelligence (AI).

As the torch passes to 2024, investors are counting on a successful Fed pivot away from restrictive policy to a more neutral stance to sustain and build on this year's gains. We think the Fed's next move will be a rate cut instead of a hike, but the timing of when that might happen could be a source of volatility. Nonetheless, we see the potential end of tightening and the start of an easing cycle as a catalyst for further gains in bond prices and a broadening in equity-market leadership. We offer three reasons why we expect a gradual shift in Fed policy ahead.

1) The labor market is gently cooling

- The spotlight was on the job market last week, with the data providing mixed takeaways but also not reversing the cooling trend that has emerged, which is likely welcomed by the Fed. The strong labor market has given consumers the confidence to spend in the face of high inflation and rising borrowing costs. But the tight conditions have also meant that the Fed might need to keep policy restrictive for longer to ensure higher labor costs don't feed into higher inflation. For 2024, we see a better balance between supply and demand for workers, driven primarily by lower job openings rather than a surge in layoffs, and last week's data support this view.

- The U.S. economy added 199,000 jobs in November, slightly more than expected, the unemployment rate fell to 3.7% (a four-month low), and the labor-force participation ticked higher, all pointing to a healthy labor market[1]. However, the return of striking autoworkers and screen actors helped boost the payroll counts by 47,000. The three- and six-month averages are holding steady, consistent with a measured downshift in job creation[1].
- Job openings in October fell for the third straight month to the lowest since March 2021. While on a clear downturn, the number of job openings remains above the 2019 pre-pandemic average, and at 8.7 million it still exceeds the 6.5 million unemployed workers[1]. Meanwhile, the number of people quitting their jobs held steady, also suggesting a less tight labor market. The job-quits rate has historically led wage growth, and with the latest data being the lowest in almost two years, it points to slower wage increases ahead.



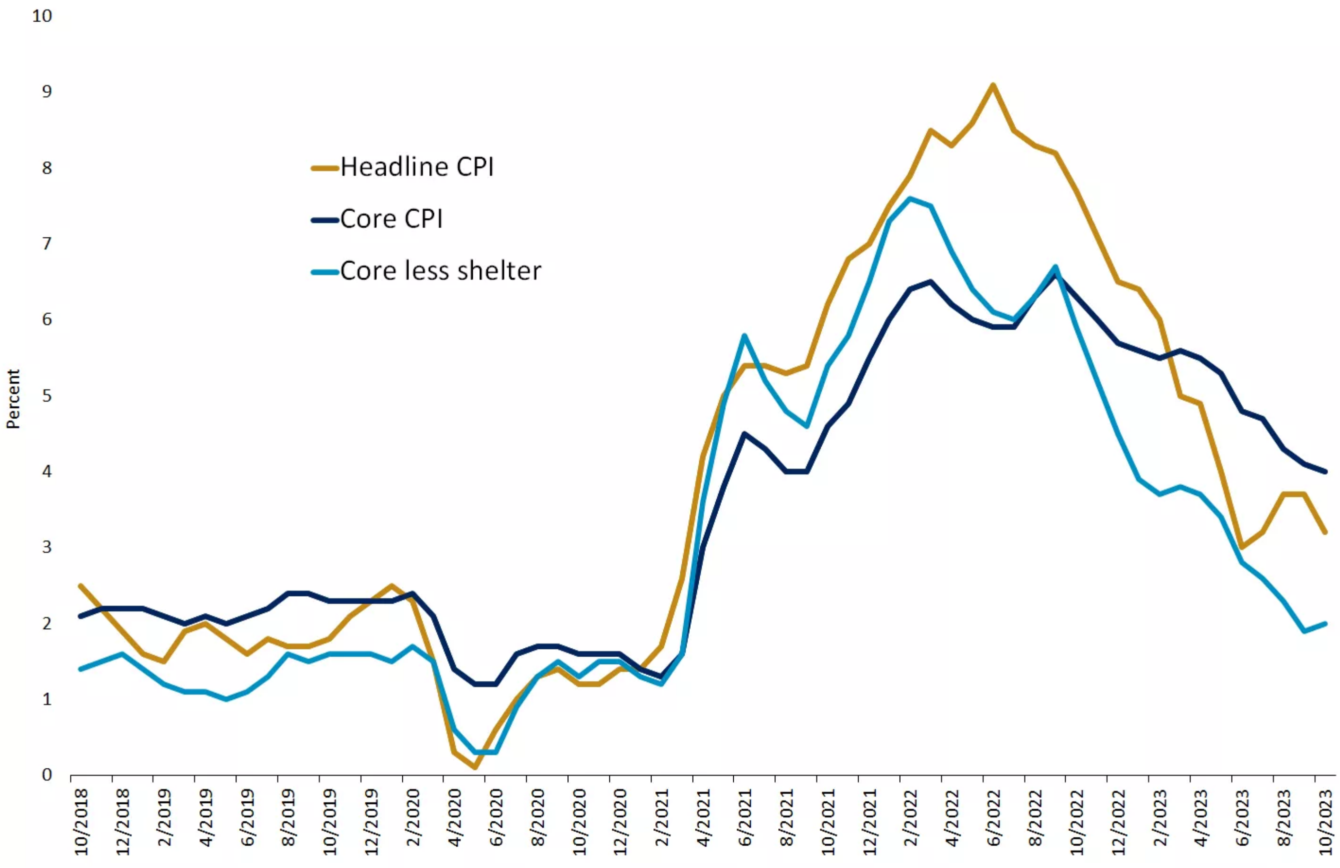
Source: Bloomberg, Edward Jones.

Chart description

2) Inflation is falling faster than the Fed projections

- Feeding into optimism for a soft landing in the economy, inflation has slowed sharply, even as the unemployment rate remains low and demand strong. In June, the Fed was projecting its preferred measure of inflation, the core personal consumption expenditures index (PCE), to end the year at 3.9%, which was then revised down to 3.7% in its September forecasts[2]. With the actual October reading at 3.5%, Fed officials will likely again mark down their inflation estimates when they meet this week, possibly taking down their projections for the fed funds rate as well.
- Housing inflation remains by far the biggest contributor to inflation. Without it, core CPI (consumer price index) has already reached the Fed's 2% over the past two months[1]. We think that more relief is on the way, as the steep decline in price increases for new leases should pull housing inflation lower through most of 2024. Beyond shelter, goods prices have been declining, and the loosening labor market, along with higher productivity, should keep wages and other services inflation in check.
- Policymakers tend to look through the volatility of commodity prices, which is why they focus on the core inflation indexes, which exclude food and energy. But prices at the pump are a significant driver of consumer expectations on inflation. On that front, the average nationwide gasoline price fell last week to $3.20, the lowest since December and down 17% over the past two months[1]. Despite the announced output cuts from OPEC+, slower growth in China and rising oil production in the U.S. have helped push prices for WTI oil down to $70. For perspective, U.S. crude exports averaged 4 million barrels per day so far this year, an all-time high and up 19% from last year[3].

Core inflation excluding shelter is now at the Fed's target



Source: Bloomberg, Edward Jones.

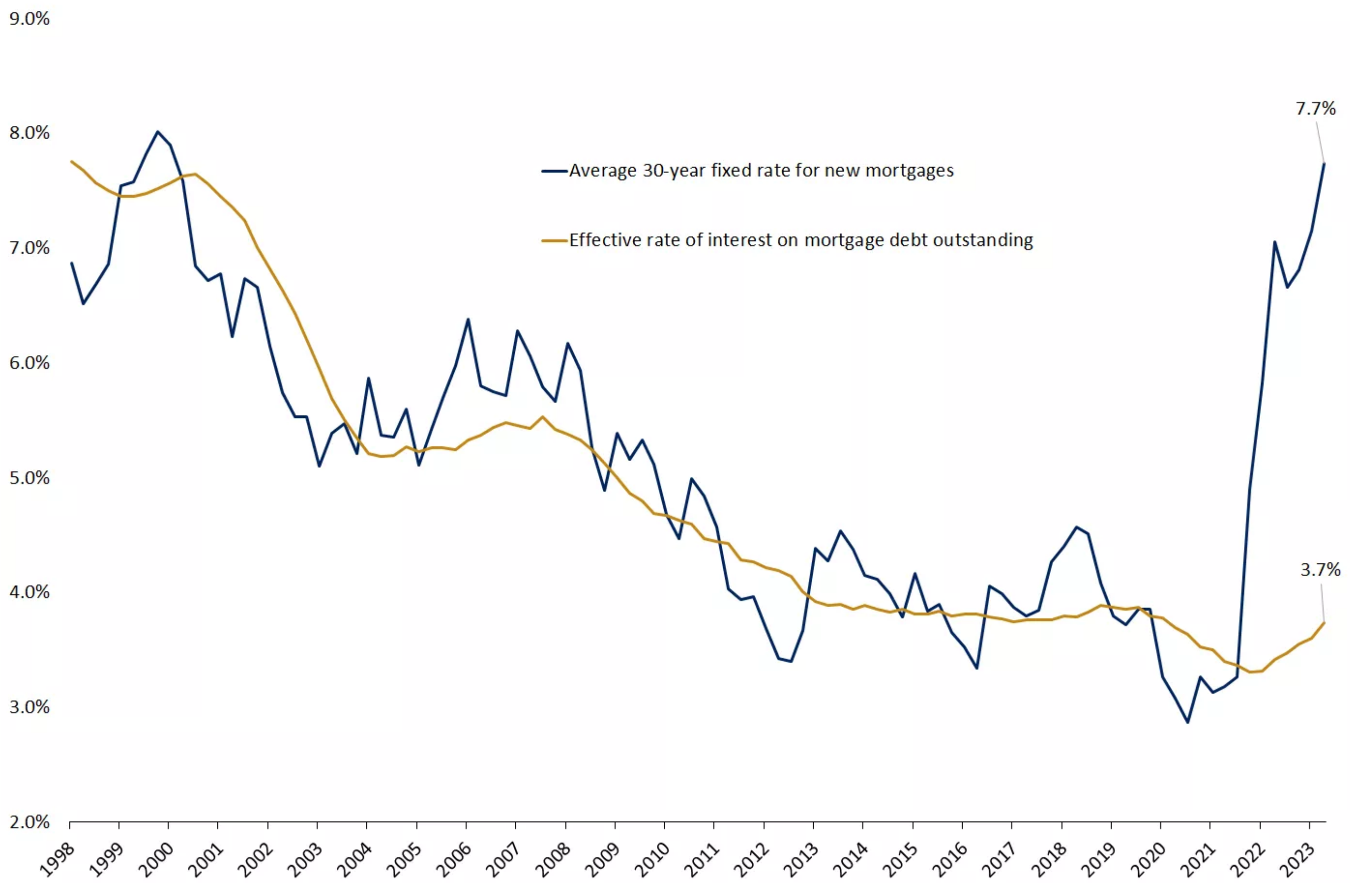
Chart description

3) Growth will likely slow from above- to below-trend in the quarters ahead

- Third-quarter annualized GDP was up 5.2%, more than twice the U.S. economy's long-term potential[1]. However, we don't expect this performance to be repeated in 2024. In the early days of the pandemic, households were able to accumulate excess savings and lock in historically low mortgage rates. This has made the economy less sensitive to the sharp rise in borrowing costs. As shown below, despite the interest rate for new 30-year mortgages averaging around 7.5% currently, the effective rate on all mortgages outstanding is less than 4%[1].
- While buffers remain, the consumer is starting to show some fatigue as the excess savings are being depleted, credit is tight, and effective rates are moving slowly higher, catching up with market rates. Moreover, the boost from elevated government spending is poised to reverse next year.
- Economic growth is tracking lower in the fourth quarter, with the Atlanta Fed's real-time GDP estimate at 1.2%[1]. A potential soft patch in the economy in the quarters

ahead could sap some of the optimism from the market, but it would also help inflation return to target sooner and support the start of a loosening in Fed policy.

Households have locked-in low rates mitigating the impact of rate hikes



Source: Bloomberg, Edward Jones.

Chart description

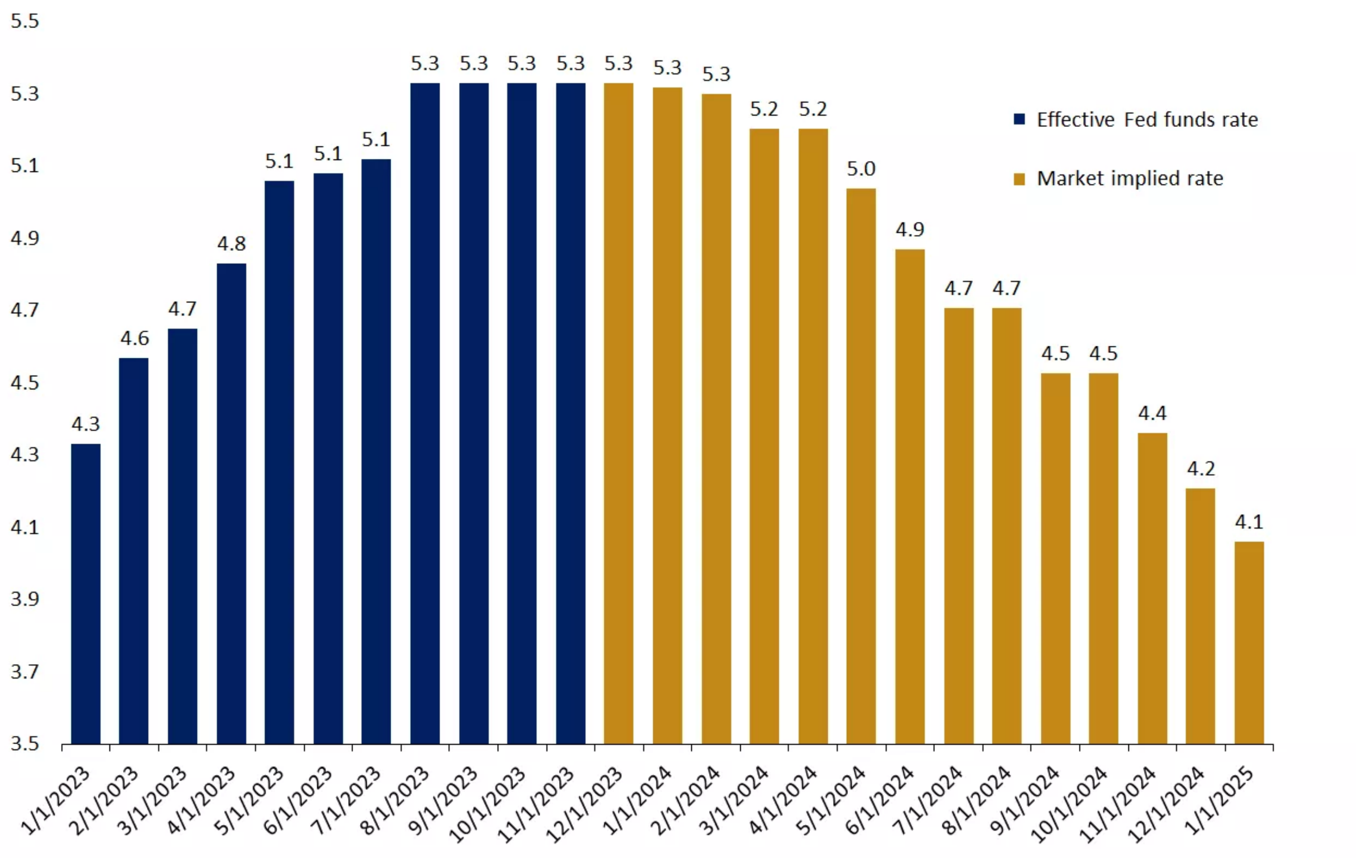
Fed vs. market expectations – A tug of war in the making?

- As inferred, economic data is laying the groundwork for the Fed to pivot, and markets are taking notice. Fed-fund futures are now pricing in rate cuts as early as March, though July was expected just few weeks ago. While Fed officials are likely interpreting the incoming data the same way, they will probably caution against pivoting to rate cuts too quickly, as that would risk unwinding some of the tightening in financial conditions that is helping apply pressure on inflation.
- A potential tug of war between market pricing and Fed messaging could drive volatility in bond and equity markets, but we expect both forces to move in the same direction as the new year progresses. This week's Fed meeting and economic

projections will provide a fresh read on how the path of rates might look. We suspect that policymakers might remove the one additional rate hike they had penciled in for this year as they likely trim their inflation forecasts. But Tuesday's CPI will likely weigh on that decision as well.

- If our base-case scenario of a couple of quarters of soft economic growth materializes, we expect the Fed to cut rates three to four times in the back half of 2024. As price pressures ease further, the real policy rate (after adjusting for inflation) will become more restrictive, which the Fed will try to offset by cutting rates more than it currently forecasts. In this scenario, we see the 10-year Treasury yield falling slightly below 4% by the end of 2024.
- Two other scenarios that should not be dismissed but are less likely, in our view, are 1) that of a "no landing," where the economy stays strong and inflation persistent, in which case the Fed holds rates steady for the full year, and 2) that of a more traditional recession, where the Fed will cut rates aggressively to support the economy.

Markets are pricing in five Fed rate cuts next year starting in March



Source: Bloomberg.

Chart description

A Fed shift is a potential catalyst for laggards to start catching up

- Uncertainty about the economic and interest-rate outlooks, together with excitement around AI, has led investors to flock to U.S. mega-cap tech stocks. The Magnificent 7 (Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia, Tesla) have driven most of the S&P 500 gains and have outperformed small-cap stocks by 100% this year[1].
- However, a subtle shift appears to be underway, as the rally has started to spread beyond big tech. Over the past month the Magnificent 7 have trailed small-cap stocks by 7%, while the "average" stock, proxied by the S&P 500 equal-weight index, has made up some of the lost ground[1].
- While a couple of weeks don't make a trend, we think that interest-rate stability because of an upcoming Fed pivot could be the catalyst for a rotation from this year's winners to the laggards. In our view, narrow market leadership and wide valuation gaps have created an opportunity in areas of the market that have been left behind. These may include bond proxies like the traditional defensive sectors at first if the economy enters a soft patch early in 2024, and small-caps along with value-style investments later as growth reaccelerates.
- No doubt 2024 will bring its own twists and turns in the market narrative, but there are reasons for cautious optimism. Interest rates have likely peaked, as the Fed starts paving the road for rate cuts, inflation continues to moderate, and valuations outside of the big year-to-date gainers remain reasonable.

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Sources: 1. Bloomberg, 2. FOMC Summary of Economic Projections, 3. Energy Information Administration

Weekly market stats

INDEX	CLOSE	WEEK	YTD
Dow Jones Industrial Average	36,248	0.0%	9.4%
S&P 500 Index	4,604	0.2%	19.9%
NASDAQ	14,404	0.7%	37.6%

INDEX	CLOSE	WEEK	YTD
MSCI EAFE*	2,138	0.4%	10.0%
10-yr Treasury Yield	4.23%	0.0%	0.3%
Oil ($/bbl)	$71.20	-3.9%	-11.3%
Bonds	$96.93	0.1%	3.3%

*Source: FactSet, 12/8/2023. 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 November CPI inflation data and the FOMC meeting.

[Review last week's weekly market update](#).

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Market Data

DJIA 36,301.28 ↑ (+53.41)

S&P 500 4,606.14 ↑ (+1.77)

NASDAQ 14,374.87 ↓ (-29.11)
