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Weekly market wrap

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‹ Weekly market wrap

Market volatility returns: Our take

on three drivers of the recent market pullback

Key Takeaways:

- *After a 25% run higher in the S&P 500 over the past six months, the tone in the markets in recent weeks seems to have shifted. The S&P 500 closed lower for the third straight week, while the technology-heavy Nasdaq was lower for the fourth week in a row. The magnitude of the pullback thus far has been relatively contained: The S&P 500 is down about 5.5% from recent highs, while the Nasdaq is down around 7%. However, the interest-rate-sensitive parts of the market, including small-cap stocks and the real estate sector, have pulled back more. And the VIX volatility index, sometimes referred to as the "fear index," has climbed toward highs of the year.*
- *In our view, volatility has been sparked by a trifecta of recent data and news. First, the market has repriced Fed rate cuts and is now expecting just one rate cut in 2024, and it is adjusting to this new "higher for longer" interest-rate regime. Second, geopolitical tensions have been rising, particularly in the Middle East, which has also put upward pressure on oil and commodity prices in recent weeks. And third, S&P 500 first-quarter earnings season is underway, and while companies are beating forecasts, the outlooks they are offering have been softer than expected. Mega-cap technology firms, including Microsoft, Google, and Meta will all be reporting earnings next week, with investors closely watching for signs of any weakness.*
- *Market volatility after a strong run is not unexpected. While calling the bottom of a pullback is notoriously difficult, we know that corrections in the 5% - 15% range are typical in any given year. In our view, the more important consideration is whether a pullback could morph into a deep or prolonged bear-market environment (typically with 20% or higher losses). We don't see this as a high-probability outcome, particularly given that the U.S. economy remains fairly robust, supported by strong consumer demand and a healthy labor market, and global economic growth is also stabilizing. Thus, investors could use this pullback to rebalance, diversify and dollar-cost average into weakness, especially those that hadn't fully participated in the recent rapid rally.*

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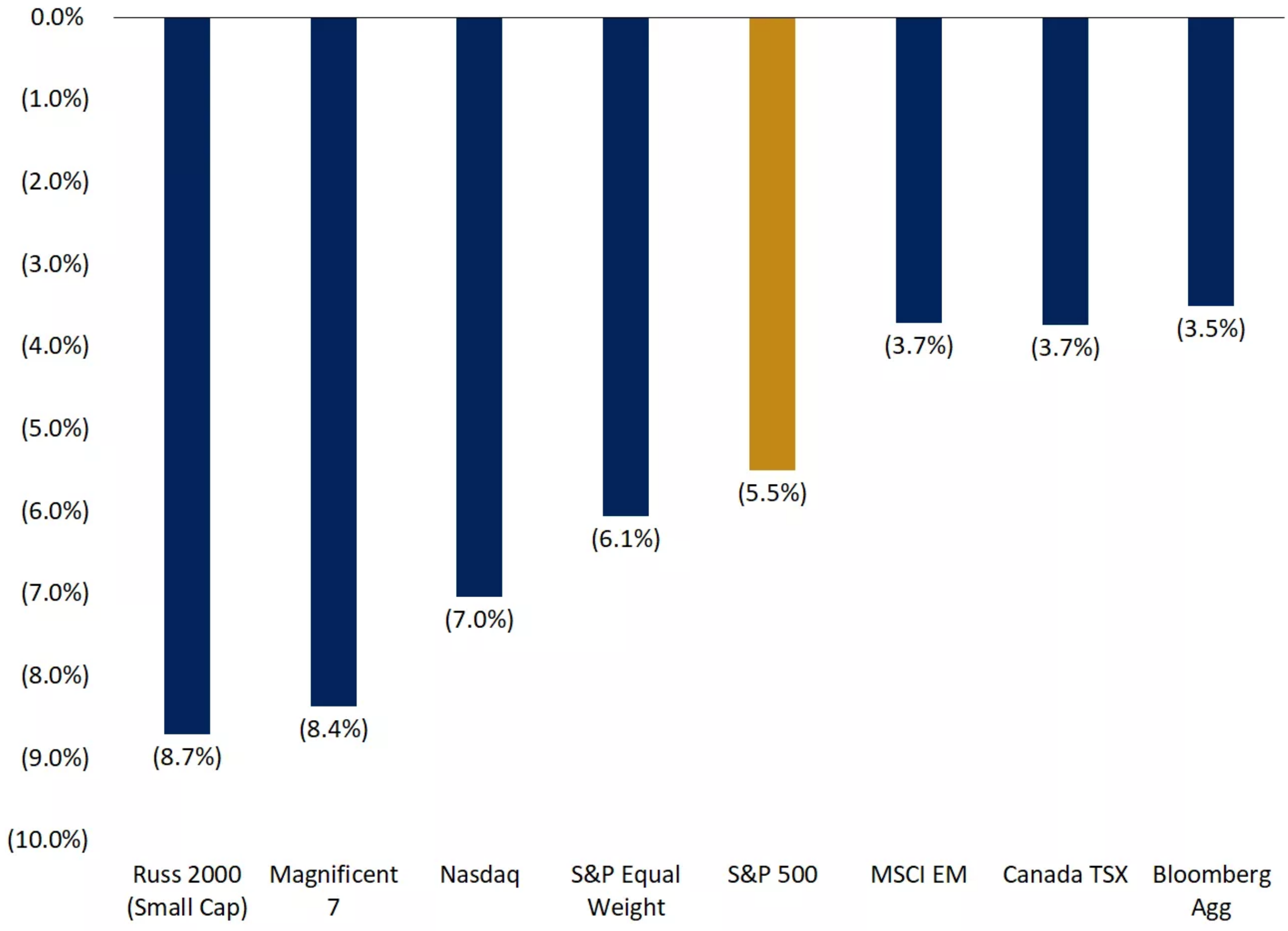
After a strong rally in the stock market, markets in recent weeks have been softening. know that market corrections are typical in any given year, and especially so after a 25%

rally in the S&P 500 over the past six months.

Growth and interest-rate sensitive parts of the market have corrected most thus far (% pullback from recent highs)



Source: Bloomberg, as of 4/19/2024. Magnificent 7 represented by Apple, Amazon, Alphabet, Meta Platform: Microsoft, NVIDIA and Tesla.

Chart description

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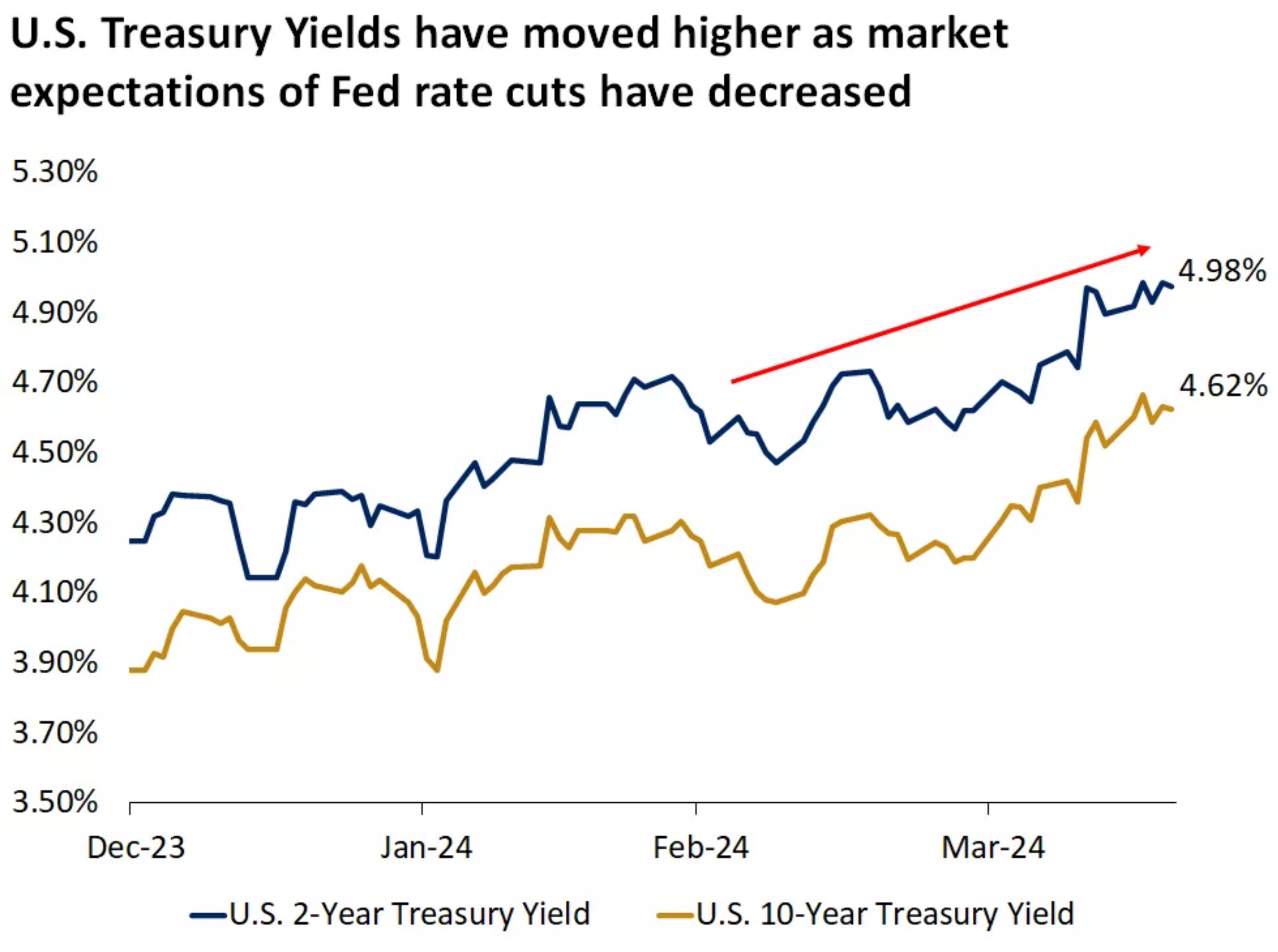
We outline three drivers for the recent market volatility, and our take on each:

1. **The market has repriced expectations for Fed rate cuts**

   In recent weeks, one of the major shifts that markets have had to adjust to is the notion that Fed rate cuts may be delayed this year or may not come at all. In fact, markets now expect just one Fed rate cut in 2024, with the highest probability for the September FOMC meeting.[1] This has been a sizable shift from the six rate cu that were priced in by markets at the start of this year.[3] As a result, we have see interest rates move higher, with the 2-year and 10-year Treasury yields back near the highs of the year, and stock markets move lower. In particular, interest-rate-sensitive parts of the market have underperformed, including small-cap stocks and sectors like real estate, as well as bond markets broadly.



Source: Bloomberg.

Chart description

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Our take: The reasoning behind the repricing of the Fed rate cuts has been largely driven by recent U.S. inflation readings being more persistent than expected. Headline consumer price index (CPI) inflation, for example, has gone from 3.1% year-over-year back up to 3.5% in the first three months of the year.[2] These recent trends, along with strong economic growth and a resilient consumer (retail sales far exceeded expectations last month) have caused expectations for the Fed rate cuts to be pushed out yet again.

However, while inflation has been bumpy in recent months, we would highlight a couple of key factors. First, inflation has come down substantially already. In the

U.S., headline inflation has gone from 9.1% in June 2022 to 3.5% last month.[2] Most investors had expected this last mile from 3.5% to 2.5% (or lower) to take some time and not move in a straight line lower, precisely the environment we are seeing today. Second, there have been parts of inflation that surprised to the upside, including areas like motor vehicle insurance and health care services, alongside the expected moves higher in oil and energy prices. But overall, the parts of inflation most watched, including shelter and rent, have remained contained.

In our view, there was nothing yet in recent inflation reports to suggest that some of the recent disinflation trends have ended and inflation has been reignited in a meaningful or sustained way. In fact, the recent labor-market reports that show an easing trend in wage gains also help support this point of view.

2. **Geopolitical tensions have emerged once more, causing uncertainty in markets and commodity prices**

In recent weeks, we have also sadly seen a re-escalation of geopolitical tensions, centered around the emerging conflict between Israel and the Middle East, which has also driven market volatility. While geopolitical tensions are hard to handicap, they tend to manifest most directly in the commodity markets and, in this case, the oil markets. As news of escalation between Israel and Iran surfaced, we saw WTI crude oil prices move higher towards $87 per barrel, a high for the year. However, in recent days we have seen oil and commodity prices broadly move back lower, perhaps because of the notion that tensions may have cooled a bit.

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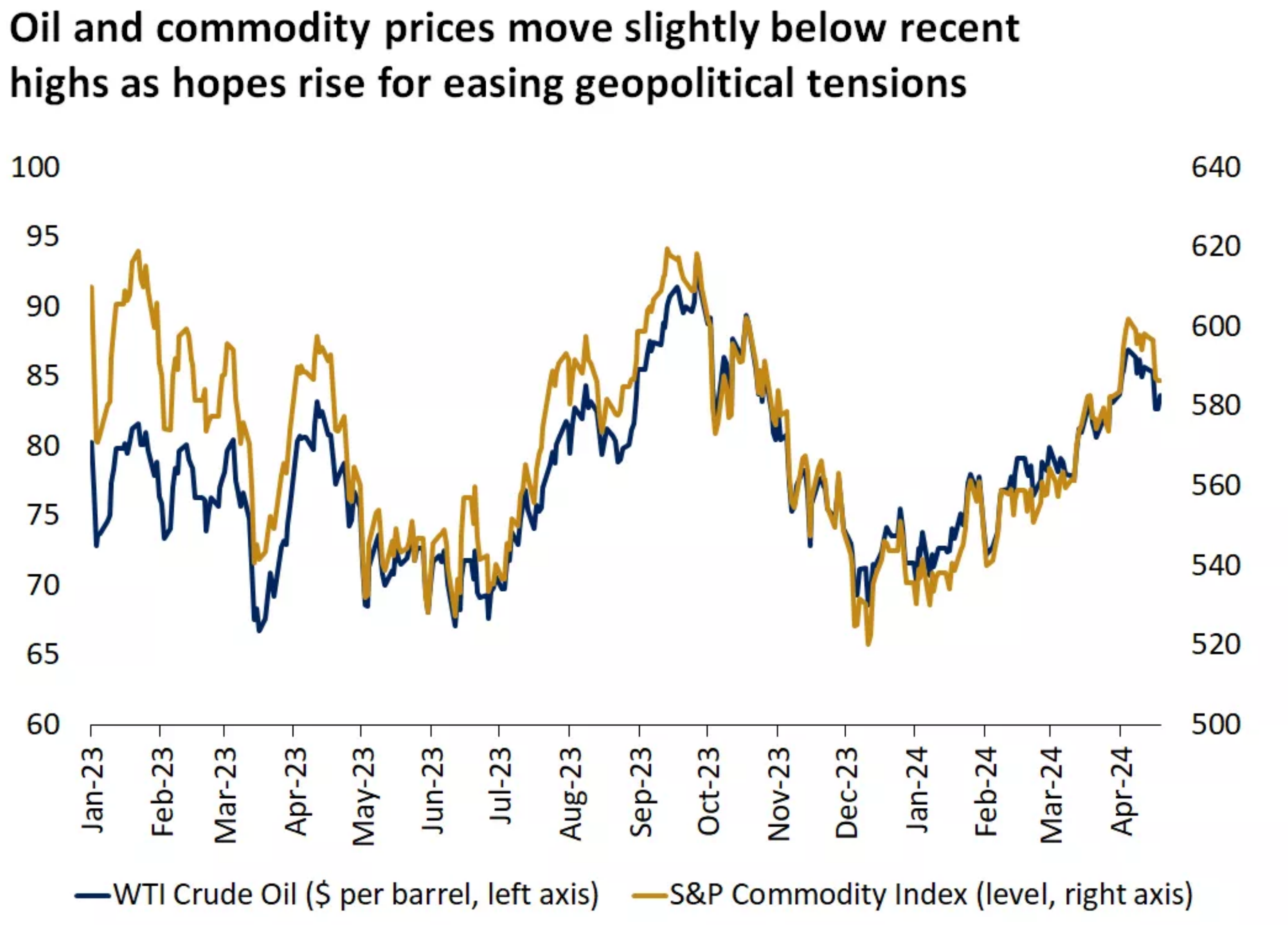

Source: Bloomberg.

Chart description

Our take: Perhaps a primary concern for investors around the recent geopolitical tensions may be the risk of the oil supply being severely disrupted in an economy like Iran. However, given available supply in both OPEC+ and in the U.S., we see this risk is also diminished to some extent, as supply can be brought online if needed, and this may be getting reflected in commodity markets lately. Particularly in an election year, the U.S. would, in our view, favor stability in commodity markets and the economy in the months ahead.

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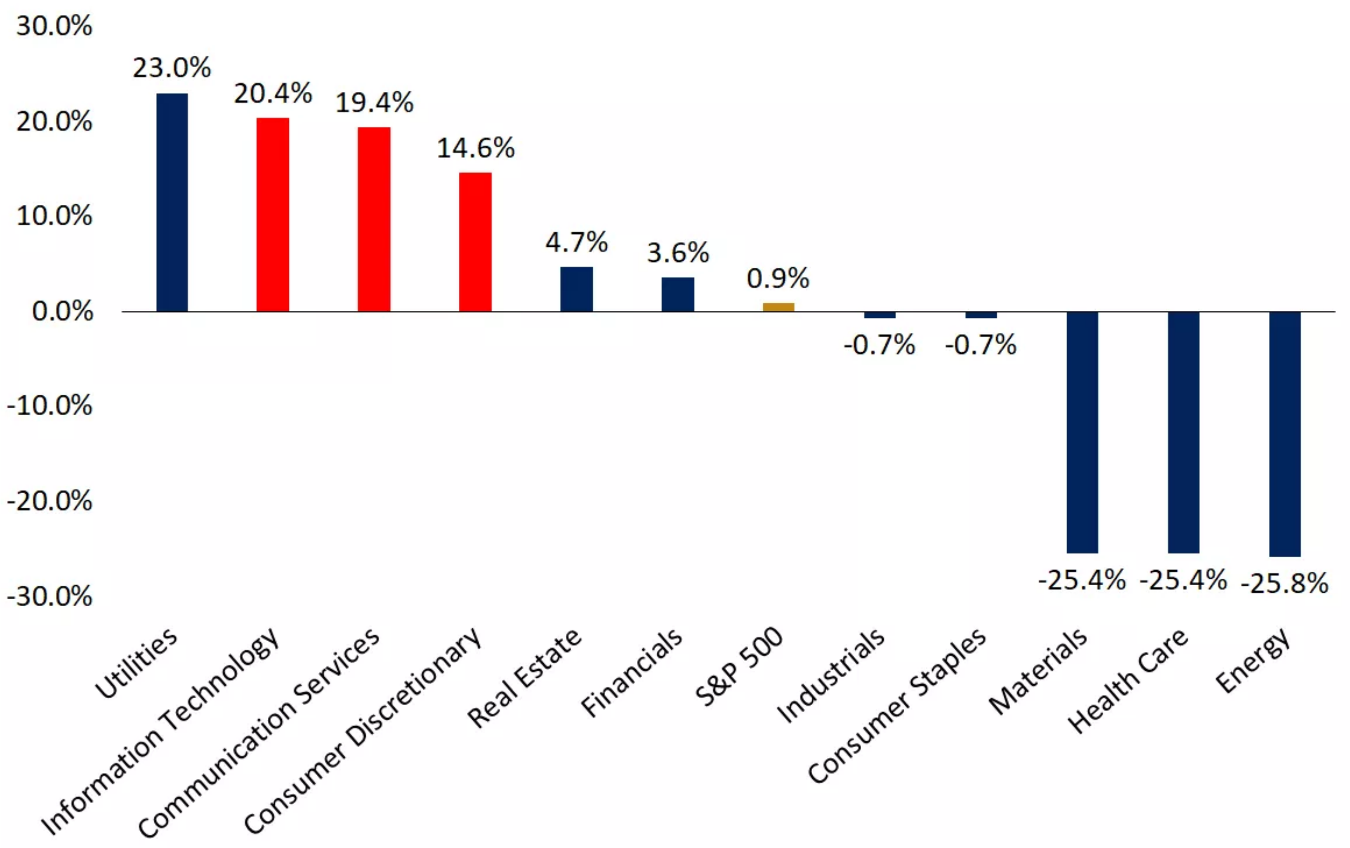
One other factor to consider as well is that the global economy seems to be stabilizing, which could also serve as a demand driver for global commodities broadly. China's first-quarter GDP growth has come in at 5.3% annualized, exceeding expectations, and emerging markets broadly are showing more signs of economic activity.[2] This puts a floor on oil and commodity prices as well, so while we may see some near-term relief, we would not expect oil to return to the sub-$70 prices we saw at the end of last year.

3. **Earnings season will continue to take center stage; mega-cap technology up next week**

   The third driver of recent market volatility – and perhaps of future volatility – has been first-quarter earnings season. While it is early days still, with about 14% of S&P 500 companies having reported earnings, we have already seen some market indigestion emerge over corporate earnings and the outlook.[2] In particular, the large U.S. banks, which are typically the first to report, overall exceeded earnings expectations. However, there was rising concern on bank guidance, and whether net interest income could be maintained in this new "higher for longer" interest-rate environment, as the cost of holding deposits remains elevated. As a result, the financials sector pulled back last week, as expectations for future earnings were adjusted lower.

   Our take: Next week, several large mega-cap technology companies will report earnings, including Microsoft, Google and Meta (Facebook). The expectations are high for these companies heading into earnings season, and while they have pulled back 6%-7% in recent days, the stocks are still up over 20% each since late October 2023.[2] Given the focus on guidance, it will be important for these companies to deliver solid outlooks for market volatility to remain contained in the technology and growth sectors. Keep in mind that these are the higher-volatility parts of the market, and they tend to pull back more than the broader market in periods of down markets. However, strong earnings results and favorable guidance could reignite some positive momentum in the technology-driven sectors and the markets more broadly.

Expectations for Q1 earnings growth remain high for technology and growth sectors
(S&P 500 Sectors: Q1 Earnings Growth Forecast, year-over-year %)



Source: FactSet.

Chart description

Overall, while the market tone has shifted in recent weeks, with yields moving higher and most stock market indexes moving lower, thus far the magnitude of the pullback has bee contained. And after a 25%+ rally in the S&P 500, a period of consolidation or some profit-taking was expected. In our view, the key consideration is whether the recent pullback could turn into a deep or prolonged bear-market environment (with greater thai 20% drawdowns across multiple sectors). We don't yet see the scope for this for two primary reasons:

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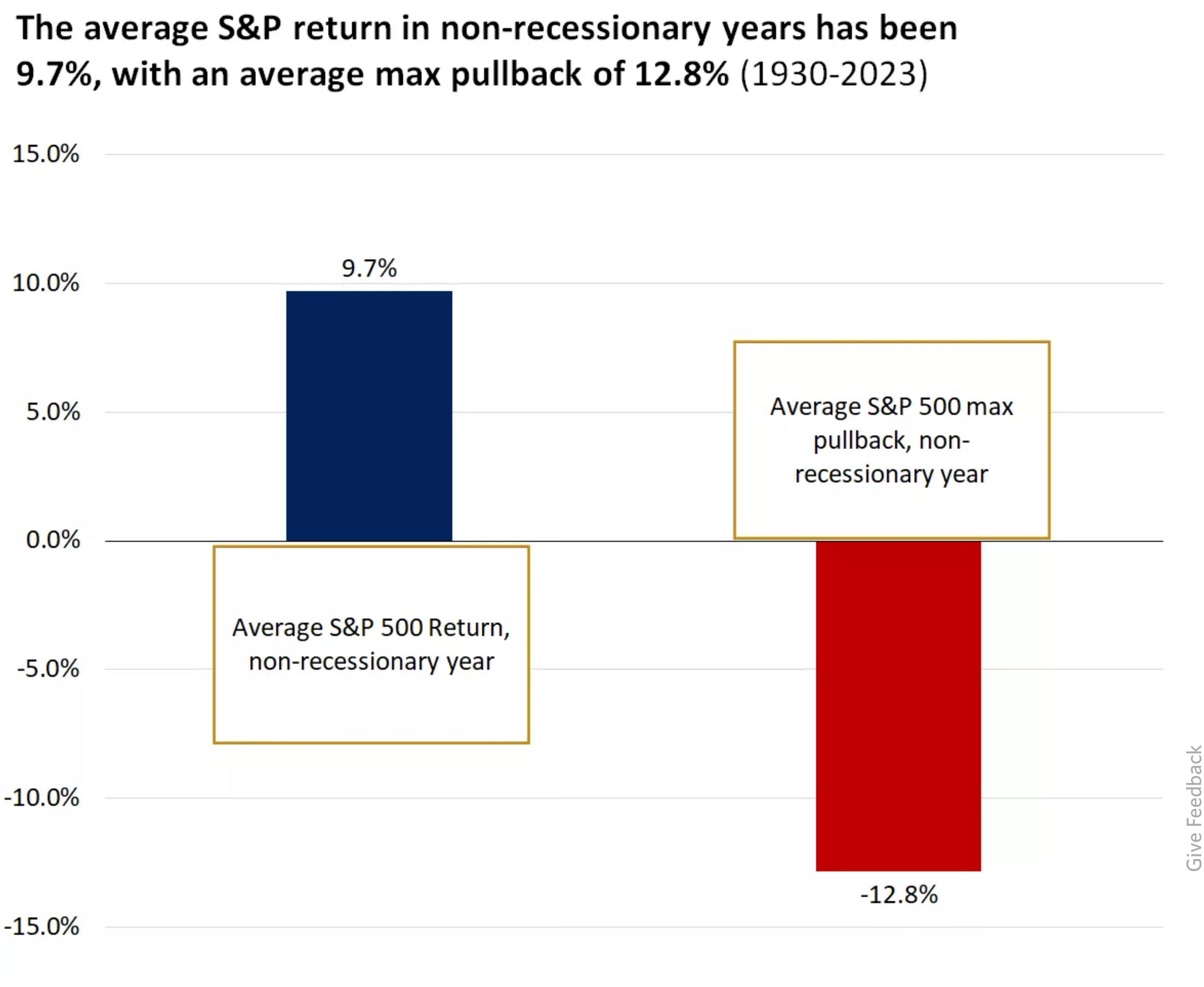
1. First, bear markets tend to occur when the economy is in a recession or entering a recession. We see neither of those conditions in place today. In fact, the economy continues to remain resilient, and last week's U.S. retail figures (which doubled expectations) underscore a healthy consumer still.

2. Second, bear markets also tend to occur when the Fed is hiking rates. In our viev the bar for rate hikes remains high for the Fed, and while inflation has been

persistent, we don't yet see conditions in place for it to reignite sustainably. We believe the Fed will be patient but will likely still consider a rate cut as its next move.

Thus, while the duration and magnitude of any correction is difficult to predict, we believe investors can consider using this period of volatility to rebalance, diversify, and use dollar-cost averaging to gradually add quality investments to portfolios at better prices – ahead of a potential recovery period partly driven by lower rates in the coming year.



Source: Morningstar Direct, Edward Jones. S&P 500 Price Return Index. U.S. recessionary periods as defined by NBER.

Chart description

Mona Mahajan
Investment Strategist

Sources: 1. CME FedWatch Tool 2. FactSet 3. Bloomberg

Weekly market stats

INDEX	CLOSE	WEEK	YTD
Dow Jones Industrial Average	37,986	0.0%	0.8%
S&P 500 Index	4,967	-3.0%	4.1%
NASDAQ	15,282	-5.5%	1.8%
MSCI EAFE*	2,248	-1.8%	0.5%
10-yr Treasury Yield	4.62%	0.1%	0.7%
Oil ($/bbl)	$82.13	-4.1%	14.6%
Bonds	$95.38	-0.6%	-3.1%

*Source: FactSet, 4/19/2024. 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 first-quarter GDP and PCE inflation data.

Review last week's weekly market update.

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Mona Mahajan

Mona Mahajan is responsible for developing and communicating the firm's macroeconomic and financial market views. Her background includes equity and fixed income analysis, global investment strategy and portfolio management.

She regularly appears on CNBC and Bloomberg TV, and in The Wall Street Journal and Barron's.

Mona has a master's in business administration from Harvard Business School and bachelor's degrees in finance and computer science from the Wharton School and the School of Engineering at the University of Pennsylvania.

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Market Data

DJIA 37,986.40 ↑ (+211.02)

S&P 500 4,967.23 ↓ (-43.89)

NASDAQ 15,282.01 (0.00)

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