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Weekly market wrap

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‹ Weekly market wrap

Early rate cuts? Not so fast -- but

easing is on the horizon

Key Takeaways:

- The trend of inflation remains lower, and leading signals suggest further moderation ahead, but the road to the Fed's 2% target could be bumpy and require patience.
- The timing of when the first rate cut might be delivered could be a source of volatility. However, the big picture is that Fed policy will most likely be easing in the back half of the year.
- The rebound in forward earnings, together with new market highs, provides confirmation that the uptrend in stocks remains intact.
- We see opportunities to buy potential pullbacks as markets digest last year's gains; to diversify into the lagging segments of the equity market; and, if overweight CDs and other cash investments, to extend duration ahead of the start of an easing Fed cycle.

"Inflation" and "the Fed" were two of the most used words in financial-market commentary in 2023 as the economy continued to navigate an unconventional cycle. The first full trading week of 2024 brought us a fresh read on consumer prices and more discussions about how the path of rates might look. We offer our take on the debate around the timing of potential rate cuts. Additionally, we share insights into where we see opportunities as markets potentially enter a choppier phase.

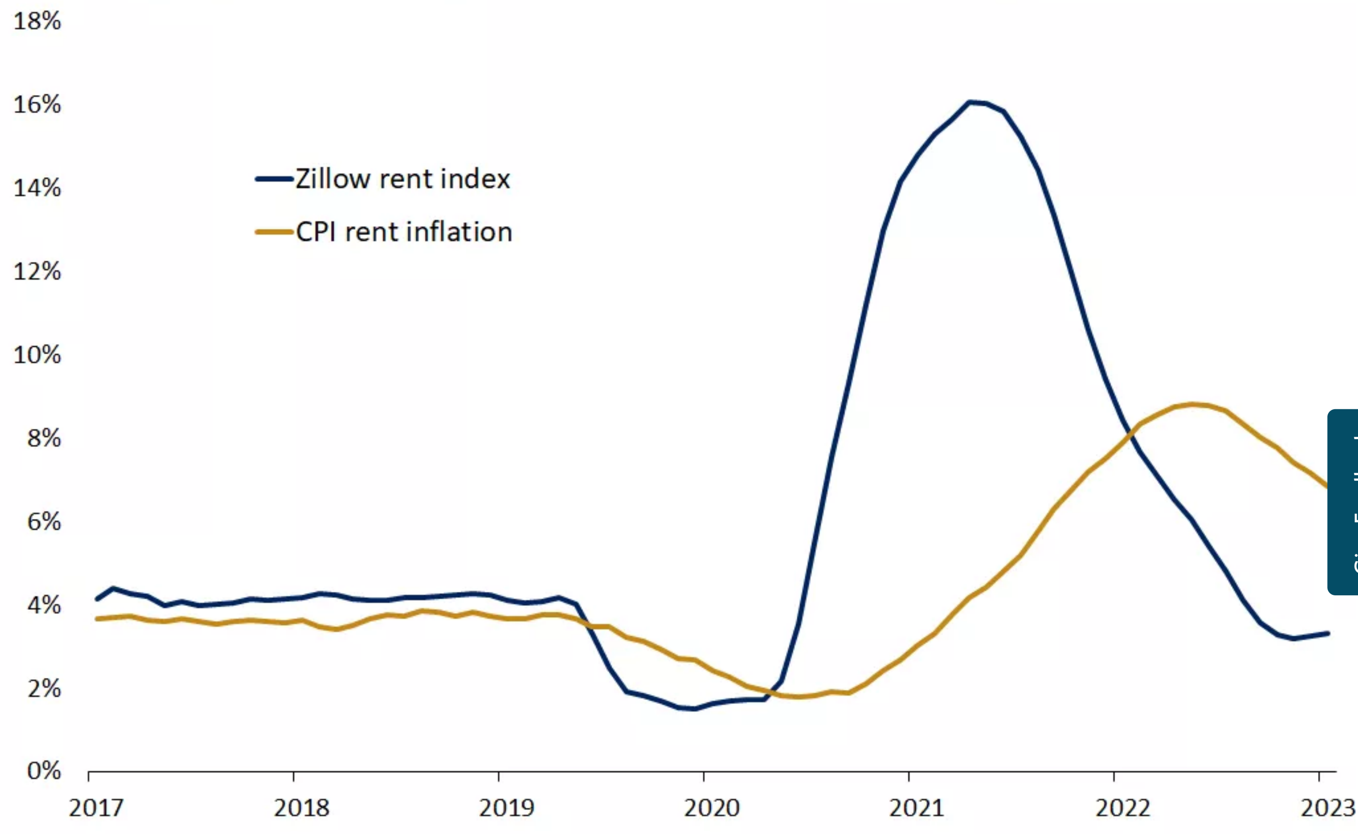
Uptick in CPI is a reminder that navigating the "last mile" might require patience

- **What we learned:**
  - All eyes were on the release of the consumer price index (CPI), which increased 3.4% in December from a year ago, a slight acceleration from last month's 3.1% reading. Core CPI, which excludes food and energy, continued to slow, falling to 3.9% from 4%. While that was the lowest reading in two and half years, and was mostly in line with forecasts, core inflation is still well above the Fed's target[1].
  - Most of the upside was driven by services costs and specifically shelter, which contributed over half of the overall increase in inflation. Additionally, car insurance costs surged 20% from a year ago, the most since 1976, and use car prices increased over the past month against forecasts for a decline[1].

    - Beyond used vehicles, inflation for other goods declined slightly from the prior month, and price pressures for several services categories moderated.
- **Key take:**
    - The trend of inflation remains lower, but the road to the Fed's 2% target could be bumpy, as the "last mile" might be harder to navigate than the 2023 slide when the CPI was north of 6%. Some components of services inflation are proving persistent. Yet, we think it will continue to slowly normalize through the course of the year.

- **Six positive signals and one headwind:**
    - We think the following signals suggest that inflation will remain on a downward path.
        1. Increases in rents for new leases have slowed and largely normalized after their 2022 spike. However, this is not yet fully reflected in the shelter CPI, which tends to lag the more timely market-based indicators by several quarters, as shown below[1].
        2. Used car prices have further to fall, as suggested by the wholesale auction market.
        3. The decline in job openings and the quits rate indicate a cooling in the labor market, which should lead to slower wage growth and, therefore, slower parts of services inflation.
        4. Consumer inflation expectations, which feed into actual inflation, are moving lower. The New York Fed's latest survey released last week showed the lowest one-year inflation expectations in three years[1].
        5. In contrast to CPI, the producer price index (PPI), also released last week, came in below expectations and unexpectedly declined 0.1% from the prior month[1]. The downside pressure in wholesale prices should help lower consumer price inflation.
        6. Energy prices are volatile and are affected by geopolitical uncertainty, which is certainly elevated now. But WTI prices are around $73, which is near the low end of their two-year range, as are gasoline prices[1].

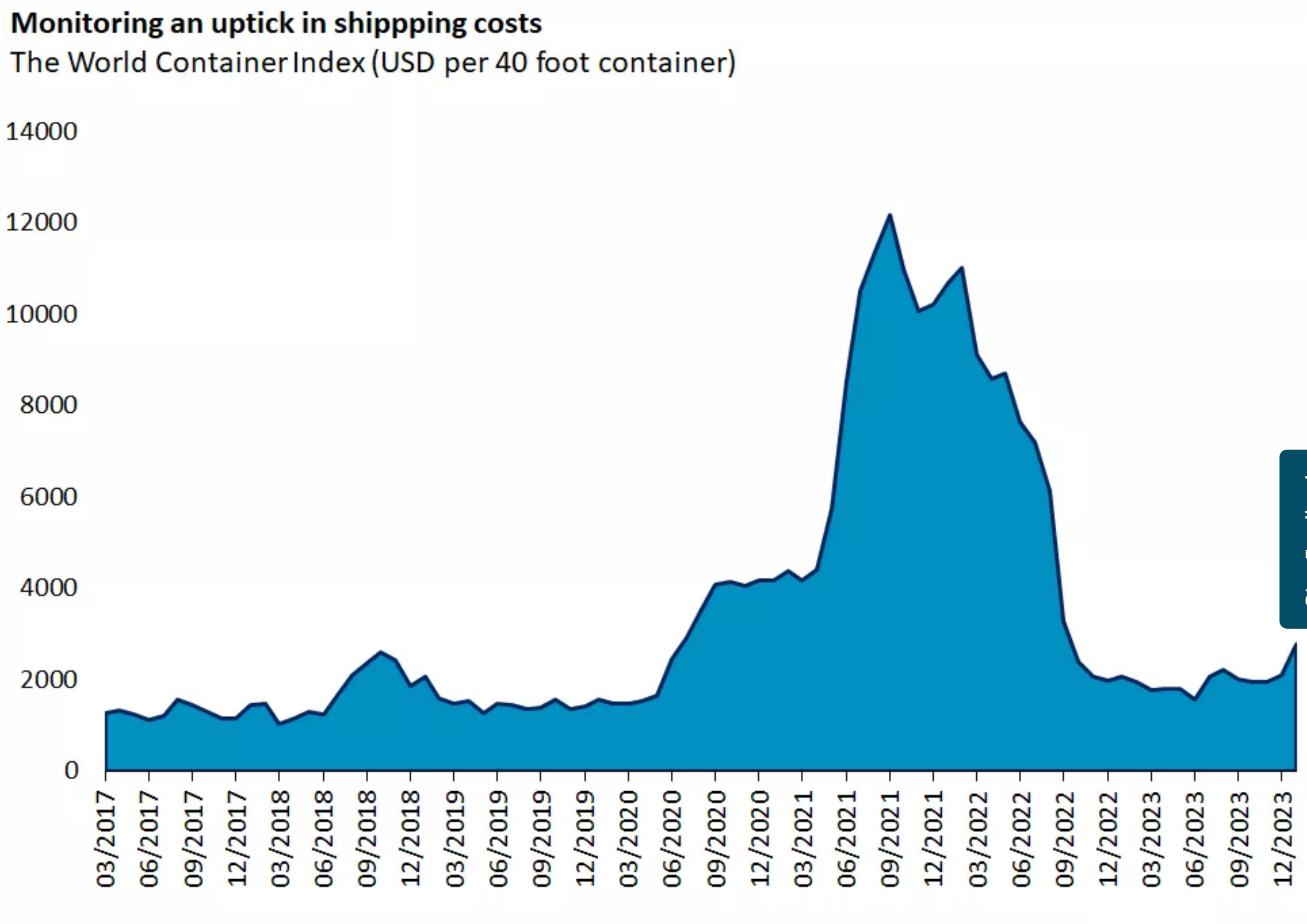
Timely data suggest that rent inflation will continue to moderate through 2024



Source: Bloomberg, Edward Jones.

Chart description

- One recent headwind is the growing risk to supply chains from disruptions across the Suez Canal. The recent attacks in the Red Sea have forced major shipping companies to divert their vessels to avoid the region and reroute around Africa, adding to shipping costs and time to transport. The current disruptions are pushing shipping prices higher and could flow through to consumer prices if they persist. However, their impact should be muted relative to the 2021 supply-chain issues. Since then, company inventories and shipping capacity have increased, while consumer demand for goods has moderated.



Source: Bloomberg, Edward Jones

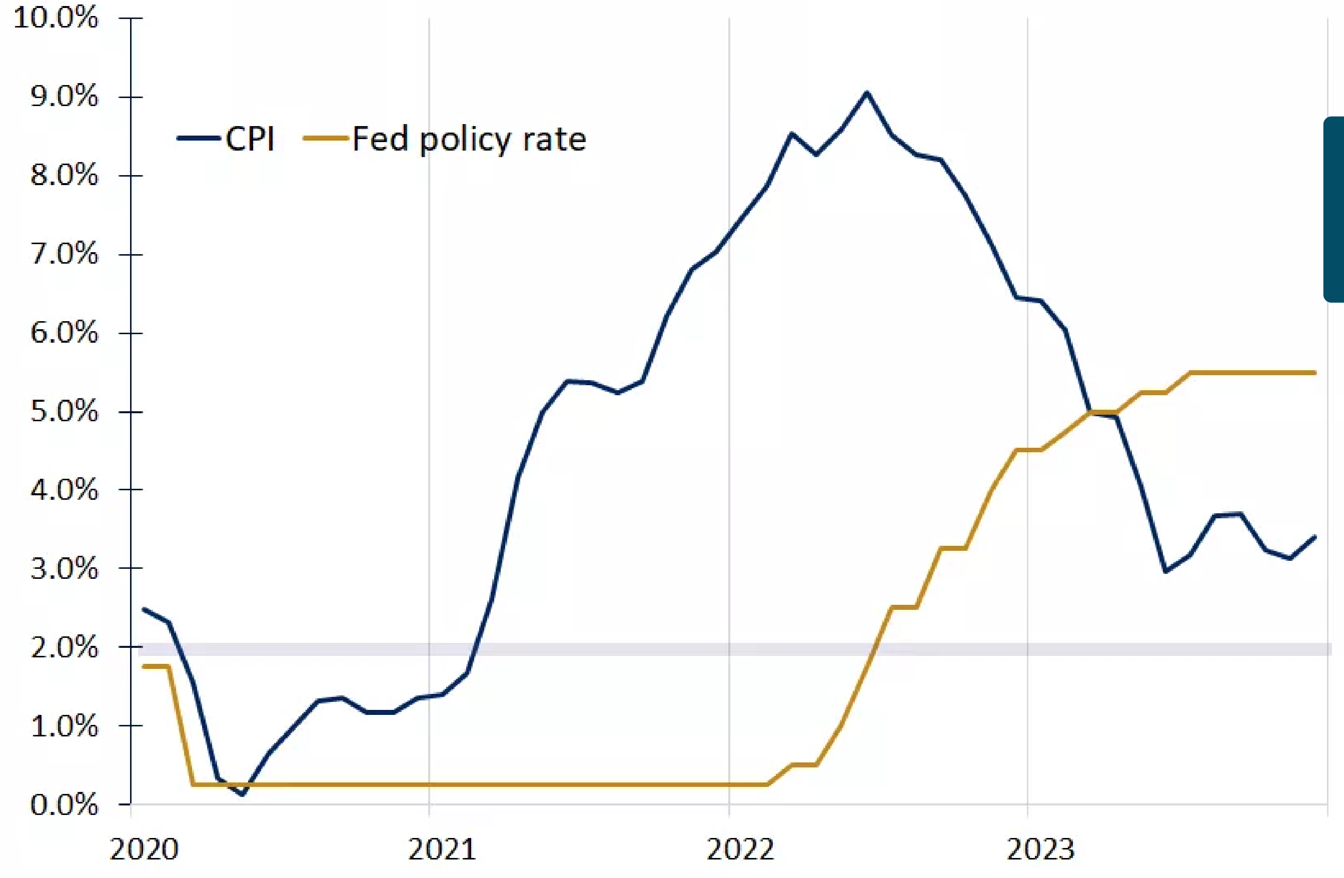
Chart description

The timing of the first cut could be a source of volatility, but easing is likely on the way

- Last week's inflation data suggest that the Fed might not rush into cutting rates, as some market participants are expecting. The bond market is currently pricing in a 75% chance that the first rate cut will be delivered in March and that there will be two more rate cuts by June, which appears somewhat aggressive to us[1]. It is possible that at the first Fed meeting of the year at the end of the month, policymakers might push back against these expectations.
- There will be two more inflation readings and two jobs reports before March, so the debate will continue. In our view, the timing of when the first rate cut might be delivered could be a source of volatility, but that doesn't change the broader theme that policy will most likely be easing in the back half of the year as inflation moves closer to the 2% target. While the path to lower inflation will not be a straight line, it should allow the Fed to start pivoting to a more neutral stance. A less restrictive

policy will be market-friendly, if it's based on easing price pressures rather than economic weakness.

Progress in inflation is a reason to expect less restrictive Fed policy in 2024



Source: Bloomberg, Edward Jones.

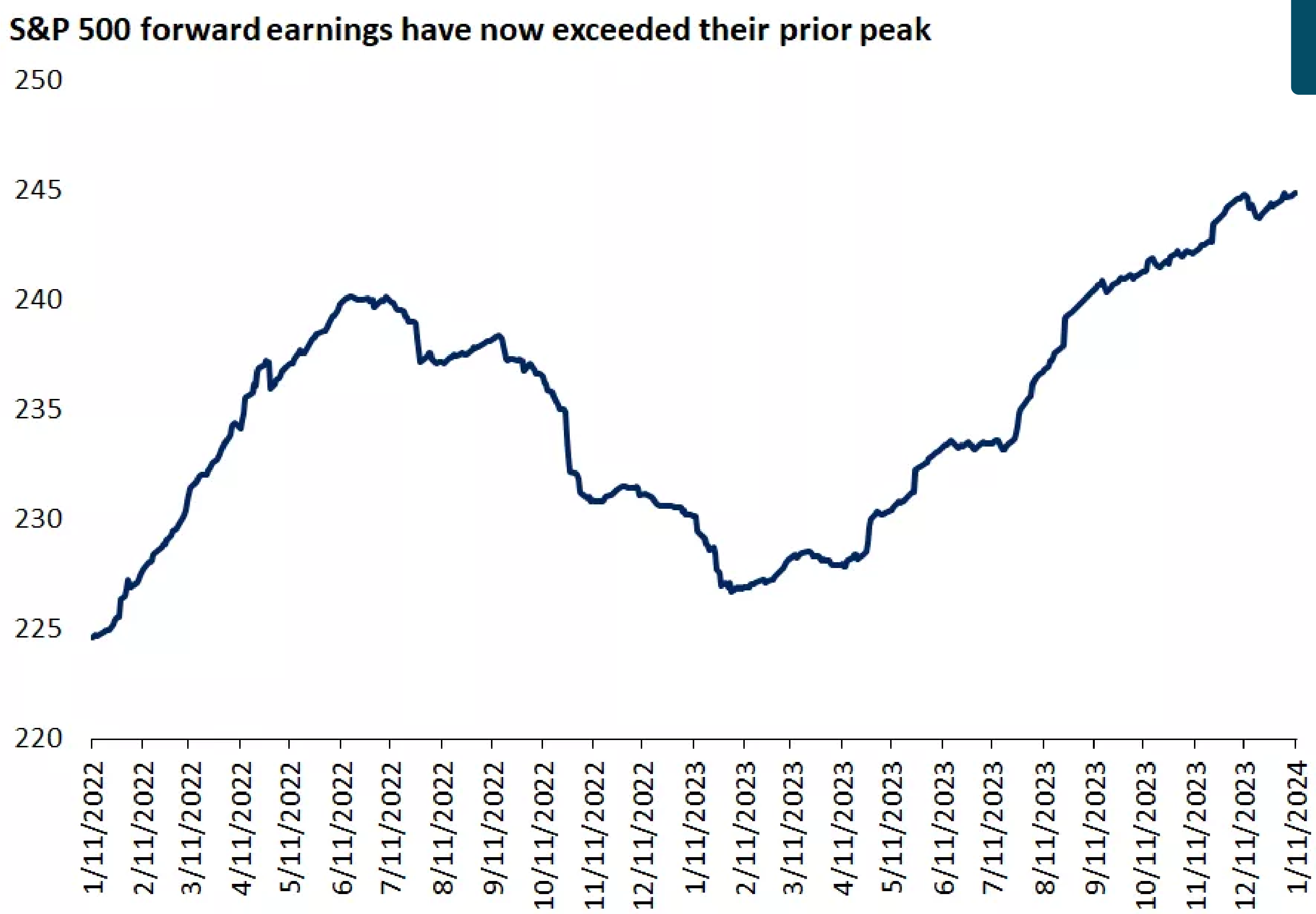
Chart description

Rebound in earnings may bode well for further market gains

- Bank earnings kicked off the fourth-quarter earnings season on Friday, and with the sector rallying over the past two months, stocks pulled back in response to mixed earnings. While most of the reported bank earnings beat expectations, several projected lower net interest incomes ahead (the difference between what a bank earns on its assets and what it pays on its debts).
- More broadly, economic resilience has helped corporate profits hold up better than expected despite cost pressures and high borrowing costs. That said, last year,

corporate profit estimates declined about 6% in nominal terms from their peak, and a little more than 10% in real terms (after adjusting for inflation).

- Expectations are that earnings will reaccelerate this year, which should be supportive of equities, even as we assume that valuations might not have much more room to expand further (especially the case for the mega-cap tech stocks). As shown below, the forward 12-month estimates for the S&P 500 are now exceeding their 2022 peak, which, in our view, provides one confirmation that the uptrend in stocks remains intact despite the relatively cautious market tone to start the year[2].



Source: FactSet, Edward Jones.

Chart description

- Together with rising corporate profits, a stock-market recovery that is accompanied by new highs tends to be a positive signal for future performance rather than a sign of exhaustion. The Dow reached a fresh record high in the first trading day of the year, and the S&P 500 hit a new intraday high on Friday. Historically, it has taken about two to three years after a bear market to reclaim the prior highs. But once stocks exceed the prior peak, they tend to keep rising for another three years until the next bear market arrives[1].

Bull market peak	High Revisited	Months to recover	Months until next bear market
8/2/1956	9/29/1958	26	38
12/12/1961	9/5/1963	21	63
11/29/1968	3/6/1972	39	10
1/11/1973	7/21/1980	90	4
11/28/1980	11/3/1982	23	58
8/25/1987	7/27/1989	23	128
3/24/2000	6/4/2007	86	4
10/9/2007	3/28/2013	65	83
2/19/2020	8/18/2020	6	16
1/3/2022	*12/31/2023*	*24*	*?*
	Average	42	45
	Median	25	38

Source: Bloomberg, Edward Jones. S&P 500 Index.

Chart description

What are the timely opportunities as markets digest last year's rally?

- Given the magnitude and speed of the late 2023 rally, markets could enter a choppier phase in the near term, as investors wait for confirmation of the reacceleration in actual earnings (not just estimates) and a clearer direction about the timing and magnitude of rate cuts. But as long as the economy stays out of recession, inflation continues to moderate, and the Fed gradually lets off the breaks, we would view any pullbacks in both equities and bonds opportunistically relativ cash.

- U.S. large-cap technology stocks led the sizable gains in the equity market for most of 2023. However, since November, the sector has lost some of its powerful momentum, as other cyclical and defensive sectors that have lagged and are sensitive to interest-rate cuts started to look more attractive. We expect this sector rotation to continue and likely pick up steam in the back half of the year as economic growth possibly reaccelerates after a potential soft patch early on. Similarly, U.S. small- and mid-cap companies have catch-up potential, especially in the scenario where a soft or softish landing is achieved.
- Like equities, bonds also rallied hard in the last two months of 2023, with the 10-year Treasury yield falling from 5% to under 4%[1]. For yields to decline meaningfully from here the Fed must start signaling a more aggressive rate-cutting cycle than the market expects, which we view as unlikely at this stage. Yet, we continue to see an opportunity to transition some of the CD money, which is now coming due for many, toward intermediate and long-term bonds, especially if the 10-year revisits the 4.25%-4.5% range. This way investors can lock in the still-attractive yields for longer and have the potential for further price appreciation as the Fed moves toward a more neutral stance over the next two years.
- **The bottom line:** We think the early part of 2024 could offer an opportunity to buy potential pullbacks in stocks and bonds; diversify into the lagging segments of the equity market; and, if overweight CDs and other cash investments, extend duration ahead of the start of an easing Fed cycle.

Angelo Kourkafas, CFA
Investment Strategist

Sources: 1. Bloomberg, 2. FactSet

Weekly market stats

INDEX	CLOSE	WEEK	YTD
Dow Jones Industrial Average	37,593	0.3%	-0.3%
S&P 500 Index	4,784	1.8%	0.3%
NASDAQ	14,973	3.1%	-0.3%

INDEX	CLOSE	WEEK	YTD
MSCI EAFE*	2,204	-0.2%	-1.4%
10-yr Treasury Yield	3.96%	-0.1%	0.1%
Oil ($/bbl)	$72.78	-1.4%	1.6%
Bonds	$99.07	0.9%	-0.3%

*Source: FactSet, 1/12/2024. 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 data being released this week includes retail sales along with December housing starts and building permits.

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.

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The Weekly Market Update is published every Friday, after market close.

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Market Data

DJIA 37,592.98 ↓ (-118.04)

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