

December 4, 2023 – Investment Commentary

We entered December after a strong November with multiple major risks on activity. This past November ranks 7th in the all-time S&P monthly returns ever delivered. In addition, fixed income credit spreads saw a material tightening, where the bond market also had its best month since 1985. With the exception of commodities and Chinese stocks, which both struggled, November was a clear bullish month.

Why did that happen, and can the rally continue? As with most things market-related, there is not a single that would explain last month's rally, but there's one factor that could be part of the response. In sum, fears around inflation and recession declined during the month as investors welcomed data suggesting the economy is beginning to cool. Soft landings, where inflation falls without a sharp drop in economic activity are historically rare. However, recent US data was encouraging. In Europe, recent inflation data has also come in lower than expected. While economic data has been somewhat weaker.

The October Non-Farm Payrolls report came out on Friday, November 3rd, and surprised market expectations with its moderation. New jobs added surprised investors to the downside. The headline unemployment rate also ticked up (now at 3.9%). Stocks rallied on the news and never stopped going up. The coincident bond rally (price up / yield down) also helped to support a broad-based risk rally led by equities as the market priced in a 'defeat' of inflation. Meanwhile, corporate profits held up in the third quarter of 2023 now looking like the end of the earnings recession that had begun in the fourth quarter of 2022. S&P 500 earnings grew year over year this reporting season after having contracted during the prior three quarters. The market is once again forecasting rate cuts in excess of 100bps in 2024 after washing them away from their 2023 crystal ball.

November 2023 was the biggest easing of financial conditions of any single month in 40 years where seasonal year-end market strength and corporate stock buybacks seem to have been enough to fuel the market to hit recent highs. The bull case narrative is The Fed (US Central Bank) has delivered the soft landing where inflation has been tamed, employment has remained high and economic growth remains positive. Investors are dismissing China slowing down, the higher cost of capital, potential breaking of weaker companies and consumers and risks of recession for next year. The longer monetary conditions stay tight, the greater the risk of something breaking (regional banks and commercial office real estate remain key risks). Investors are less concerned about recent consumer behavior, which represents about 70% of US economic activity. Several recent changes include:

1. Consumer spending slowed down in October after student loan payments restarted,
2. Foreclosures and bankruptcies started to rise after the Fed raised rates,
3. Credit card delinquency rates are rising to pre-pandemic levels,
4. Auto loan transitions to serious delinquency category at 2008 levels and
5. Banks willingness to lend to consumers and businesses is decreasing per Senior Loan Officer Surveys.

We believe as long as the job market remains resilient, then the worry is contained that consumer behavior stops abruptly as cost-of-living bites. What if unemployment goes from a bit higher to materially higher...what if we see an exogenous shock that triggers Oil materially higher and a knock on further impact on consumers?

Equities

Santa Claus arrived early for investors as equities rallied across geographies and market caps. The S&P 500 returned 9.1%, the 4th-best monthly return for November in a century. The NASDAQ returned 10.8%; US mid cap stocks 10.2% and US small cap stocks 9.1%. Non-US Developed Market Equities (EAFE) returned 9.3% with broad strength across markets. Emerging Markets equities returned 8.0% powered higher by Korea (+16.2%) and Brazil (+14.2%). China (+2.5%) was a notable laggard.

Fixed Income

Investment grade fixed income asset classes had one of their best months on record as rates fell sharply across the curve.

Rates

Rates fell sharply across the curve reacting to the slowing economy and increased expectation that the Fed is done hiking for this cycle. The market expects the Fed to hold rates steady through the end of the year and now has at least one rate cut priced for March next year with a 50% probability. The peak rate for this cycle is expected to be 5.5%, which is the current target rate. Fed Chairman Powell has recently reiterated that it is too early to declare the Fed's inflation fight finished.

Source: Bloomberg

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