

January 16, 2024 – Investment Commentary

Market Movements

The optimistic case for equities and bonds that supported the last few weeks of 2023 is the combination of falling inflation, easier monetary policy (lower interest rates), and resilient growth, which provides a supportive backdrop for risk asset markets. This cocktail of macro ingredients will support growth in stocks, boost bond prices, and increase real estate demand. However, the return from a long holiday weekend is set to be a chilly one for investors as stock prices decline and bond yields rise (yield up/price down). The US market headwinds echo the same recent trading activity in Europe after some hawkish regional policymaker talk challenged market expectations regarding the magnitude and frequency of rate cuts. The Fed is likely debating cutting rates early to avoid a recession but at the risk of not addressing a sticky labor market with wage inflation or delaying rate cuts to attempt to lower wage inflation but risk an economic downturn. Lastly, oil prices (potential inflationary pressures) rose following US and allied airstrikes against Houthi rebels in Yemen as tensions continue to rise in the region.

Last week, most major US equity indices closed higher on the week except Russell 2000 small cap index flat; Nasdaq +3.1% and S&P 500 +1.8%. 2yr US govt bonds closed week-over-week down 26bps/4.14% yield (lowest since May 2023) and the 10yr down 9bps/3.96%. The S&P 500 outperformed the MSCI EAFE (non-US developed equities) and the MSCI Emerging Markets indices.

Small caps have started the year with underperformance relative to large caps, and the Russell 2000 is having its worst start to a year since 2016. Year to date (YTD) 2024, the S&P 500 was up fractionally on the year while the Russell 2000 was down 4.4%. With the S&P 500 outperforming the Russell 2000 by nearly 4.8% percentage points YTD, it is the widest margin of outperformance on the part of the S&P 500 relative to the Russell 2,000 through 1/16 on record. The price volatility of the small cap index can be explained in part by the increased uncertainty of rate cuts where approximately 40% of small cap companies are unprofitable and small cap stocks are typically more leveraged than large cap companies relying on shorter-term rate sensitive bank financing.

Fundamentals Increasingly in Focus

Following the robust Fourth-Quarter 2023 surge in US stocks, investor focus is pivoting towards companies' earnings performance and guidance. Not a great start to earnings season this past week, but we still have a long way to go. The bar for companies to beat expectations is much lower than where it was even several months ago. However, earnings reports starting with the financial sector have largely not been able to beat.

Now, a big portion of the financial earnings decline can be attributable to charges that went to the FDIC insurance fund for the regional bank issues earlier in 2023. While the financial sector is an extreme example of taking down earnings growth in Q4 2023 and moving estimates up in Q4 2024, the analyst consensus overall shows a similar trend with Q4 2024 S&P 500 earnings growth estimate at a substantial +20%. Top line nominal growth (including inflation) is slowing (like inflation) which will likely result in the need for greater cost management and margin optimization. Ultimately, at nearly a 20x forward P/E ratio on the S&P 500, fundamental earnings likely need to improve for a sustainable breakout in stock prices as continued multiple expansion may be more challenged.

This past week did not give a lot of credence to an earnings acceleration story. Wells Fargo & Co. surprised analysts by projecting a 9% decrease in net interest income for 2024, while Citigroup Inc. anticipated a modest drop in the current year. Even JPMorgan Chase & Co., while expecting its 2024 earnings to hold steady at 2023 levels, foresees a decline over the course of the year. We still have a lot of Q4 2023 earnings and forward CEO guidance to digest to determine if a soft landing is probable vs possible.

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