MARKET UPDATE

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Market Update - December 18, 2023

I. Markets

A. Stocks

Last week was the seventh straight week of gains (this has happened only 11 times since 1990): DJIA +2.92%, **S&P 500 +2.49%**, Nasdaq +2.85%, Russell 2000 +5.55%. The FOMC meeting was seen as extremely dovish. DJIA is at a record high and the S&P is just 2% below its Jan. 2022 all-time high. The equal-weighted S&P 500 outperformed the market-cap weighted index (showing that it was a broader rally). The Russell 2000 hit a 52-week high just 48 days after 52-week low.

S&P 500 is up ~23% YTD and the Nasdaq is up ~41.5% based on a stronger-than-expected economy, AI, and the prospect of rate cuts. The S&P's forward P/E is ~19. Strategists have an average year-end target of 4,838 for **2024** (barely higher than where the market is). (Barron's)

Bulls vs. bears. The **bullish** arguments include seasonality, retail FOMO, $6T in money-market funds, and possible rotation into small-caps. The **bears** worry about the possibility of a slower-than-expected pivot in monetary policy, the challenges of getting inflation down to 2% and overbought conditions. The SPX is nearing the most overbought level (RSI) in over a decade and 46% of S&P stocks have a 14-day RSI>70 (most in 30 years).

The market interprets the Fed's signal as evidence of ideal conditions: falling inflation, moderate economic growth, and lower interest rates. Of course, rate cuts could signal weakness due to tighter credit and lag impact of prior rate increases. (Barron's)

The investor consensus is that we'll have a soft landing in 2024 as inflation continues to subside and the Fed cuts rates. Remember that the consensus coming into 2023 was that we'd have a recession, a weaker dollar and emerging markets would outperform. (WSJ)

Some of the risks we could see in 2024: sticky inflation with rates moving higher, shocks (e.g., company bankruptcy, another war, etc.), concentration risk (62% of capital flows into indexes and then 30% goes into seven stocks), and the world economy could be stagnating (Europe, China, Japan). (Barron's)

Blurring the lines between trading and gambling. Option volume has averaged 44MM contracts changing hands per day YTD. This is more than double the volume from five years ago. In October, 59% of option volume was for contracts expiring in five days or less. (WSJ)

Slower trading is expected for the rest of the year. This Friday, the PCE price index for November will be released.

B. Rates and the Dollar

Yields dropped. The 10-year UST yield fell 32 bps to **3.91%**. The 2-yr yield fell 27 bps to 4.44%. The 3-month yield was unchanged at 5.44%. $**1T of corporate debt matures** and will likely need to be refinanced by 2025, so lower rates can't come soon enough.

The ratio of cash yields to stock dividends is now at the same extreme levels as 1998 before the dot-com bubble really accelerated. The ratio of the 3-month T-bill yield to the S&P 500 dividend yield is now 3.4.

The average 30-year fixed-rate mortgage was 6.95% on Dec. 14th, the lowest rate since Aug. 2022. Rates peaked in October at 7.79%. There continues to be a lack of homes for sale and home prices are high. There still will not be any refinancing since 96% of borrowers have rates below 6.9%. (Bloomberg) (Barron's)

Some large investment banks are predicting dollar strength in 2024 due to higher economic strength in the US than Europe as well as geopolitical differences. On the other hand, it's possible that the US will lower rates faster than other countries and that could result in a weaker dollar. A weaker dollar could benefit assets like precious metals and crypto. (Bloomberg)

II. The Fed and the FOMC Meeting

A. The FOMC Meeting

The FOMC left the **Fed funds rate unchanged** at 5.25% to 5.50%. The key projections from the **Summary of Economic Projections** (and change from the September projections):

1. 2023 real GDP +2.6% (projection was 2.1% in Sep.)
2. 2023 PCE inflation +2.8% (projection was 3.3% in Sep.)
3. 2023 core PCE +3.2% (projection was 3.7% in Sep.)
4. 2024 Fed funds rate 4.6% (projection was 5.1% in Sep.)
    a. Only three Fed officials see the Fed funds rate above 5% by the end of 2024

Powell says that the Fed funds rate is "well into" restrictive territory (not just "restrictive"). He no longer says that we need below-potential growth. He seems focused on risk of keeping rates too high for too long. He even admitted discussing when to start rate cuts. He said that rates would need to be cut before inflation reaches 2%.

Powell's statement that rate cuts were under discussion contradicted his statement 12 days earlier that it was premature to discuss cuts. After the meeting, NY Fed President Williams said that the Fed was not talking about rate cuts yet. It's very rare to cut rate when core inflation exceeds the unemployment rate. There's some question as to why Powell would make such dovish comments. At the same time, ECB President Lagarde said "we should absolutely not lower our guard," and the BOE's Andrew Bailey said "there is still some way to go." Norway increased rates.

The Fed funds futures market is pricing in a >50% likelihood of the FOMC cutting rates by the end of March. The market is pricing in five to six rate cuts between now and the end of 2024. Markets often get ahead of themselves on Fed policy.

B. Ideas from the Meeting

Why did the Fed pivot so sharply? Maybe to help the struggling housing market; the labor market is loosening (jobless claims rising, vacancies declining); to provide relief after bond market rout (like regional banks). Of course, there is risk of fueling a market melt-up in stocks.

The argument to loosen policy: inflation has dropped significantly – core PCE has averaged 2.5% over the last six months; the Fed funds rate is much higher than it was a year ago; with lower inflation, the real Fed funds rate is higher; the labor market is loosening; economic growth is slowing from Q3 to Q4; banks are tightening lending standards; lag effects from rate increases could still impact the economy; inflation is coming down faster than expected and is projected to be 2.4% by the end of next year.

On the other hand, part of the decrease in inflation is from the supply chain healing and more workers being available. That may be done. There is fear that the easing of financial conditions (lower yields, higher stock prices and a weaker dollar) may also make it harder for the FOMC to actually lower rates. Powell has not pushed back against financial easing. In addition, growth could be too strong to support expected cuts.

For the past two years, the Fed was focused on beating high inflation. Now, they are concerned with both inflation and employment (a balanced approach). The Fed must balance the risk of moving too slow and causing a recession (and high unemployment) versus the risk of moving too fast and allowing inflation to return. A slower economy or lower inflation would allow the Fed to cut rates.

Inflation is falling faster than Fed expected. Core PCE is 2.5% annualized over the past six months. This is allowing the FOMC to pivot. Maybe Team Transitory was right.

How the markets reacted: As mentioned earlier, the 2-year and 10-year UST yields dropped significantly and the equal-weighted S&P 500 outperformed the market-cap weighted S&P (small-caps are more interest-rate sensitive). The dollar weakened (with lower rates). Gold rallied with lower rates and a weaker dollar.

Long-term rates may already be as low as the Fed wants. Short-term rates are still high. The Fed would prefer to lower short-term rates without long-term rates falling further. Maybe the Fed could raise their long-term projections (the long-term neutral rate) from 2.5% or signal that rates need to settle at higher level than pre-pandemic.

Some economists still believe that the risk of inflation is high. Rates are quite high and the full effect of past rate increases has not been felt yet; housing and manufacturing are struggling; leading indicators are down 3.3% in past six months. But, the arguments that we will avoid a recession: unemployment is still very low; jobless claims are low; stock market is rallying.

The Fed's balance sheet totaled $7.74T as of Dec. 13. This is 9.83% lower than last year. In the spring of 2022, it was almost $9T. Pre-pandemic it was ~$4T. Will the Fed continue to tighten through QT at the same time that they are cutting rates? Powell said that changing the pace of QT is not currently under discussion – the are "on independent tracks."

(WSJ) (Bloomberg) (Bloomberg) (WSJ) (WSJ) (Bloomberg) (Barron's) (WSJ) (WSJ) (Bloomberg)

III. Other Stories About the Economy and Politics

CPI rose .1% MoM and 3.1% YoY. **Core CPI** rose .3% MoM and 4.0% MoM. Services excluding energy rose .5% MoM and 5.5% YoY. Service inflation excluding both housing and energy is still up 5.2% over the past three months. The trimmed mean CPI was 3.30%.

The Fortune 100 C-Suite is changing:

1. Average age is 57. It was 57 in 1980 but dropped to 51 in 2001.
2. Average executive has worked at 3.3 companies (was 2.2 in 1980).
3. Only 20% of executives have been at their company for their entire career (was ~40% in 1980).
4. More than 30% of executives have a finance background (up from 19% in 1980).
5. While the Ivy League accounts for less than 1% of all MBAs, they account for 23% of C-Suite executives.
6. Women have ~28% of the C-Suite positions – up from ~0% in 1980.
7. Foreign-born people account for 15% of the executives, up from ~2% in 1980. (WSJ)

The Program for International Student Assessment ranked **US students 26th in math out of 37 OECD countries**. Over 1/3 of students lacked basic math proficiency. (Bloomberg)

Nearly all cars in the U.S. are automatic transmission, freeing drivers' hands to use phones. In Europe, almost 75% of cars have manual transmissions. The US has a vehicle death rate that is almost 3X that of Canada, Australia or France and more than 4X higher than Germany or Japan, and more than 5X higher than Scandinavia, Switzerland or Britain.

Some interesting points made by longtime diplomat Richard Haass:

1. Factors contributing to global disarray:
    a. The rise of China
    b. A resurgent Russia that is able to act disruptively
    c. The decline in US global leadership
    d. Lack of international cooperation and community
2. Key perspectives
    a. Ukraine has fought Russia to a standstill. Russia can produce more weapons with the help of North Korea, Iran, and possibly China. Ukraine should shift to a defensive position.
    b. The China-Russia relationship is not as close as their "no limits" rhetoric suggests.
    c. China is still rising economically and militarily, but it has major demographic, debt, and economic challenges ahead. Xi has prioritized political control over economic concerns.
    d. The US needs to clearly state that it will defend Taiwan if invaded.
    e. Destroying Hamas militarily is not feasible. There is no clear endgame. The two-state solution is even more endangered by the latest violence. Israel is heading toward a "one-state non-solution" under Netanyahu. (WSJ)