"New Year's Fireworks"

Market Commentary – January 2024

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The third estimate of Gross Domestic Product (GDP) shows that the output of goods and services produced by labor and property located in the U.S. grew at an annual rate of 4.9% in the third quarter of 2023. While this is lower than the second estimate of 5.2%, it remains much higher than the 2023 Q2 reading of 2.1%. On December 13, the Federal Reserve revised its economic projections that were last released in September. It now sees GDP growth of 2.6% in 2023, 1.4% in 2024, 1.8% in 2025, 1.9% in 2026, and 1.8% in the "longer run" (beyond 2026). The big debate among economists is whether the Fed's restrictive monetary policy, in an attempt to calm inflation, will result in a "hard" or "soft" landing. A hard landing is a recession, while a soft landing is slowing the economy just enough to cool inflation without causing a recession. Given their GDP projections, the Fed seems increasingly optimistic that it will be successful in pulling off a desirable soft landing.

On December 13, the Federal Open Market Committee (FOMC) maintained its benchmark federal funds rate at a target range of 5.25% to 5.5%. The news-breaking item, however, was the Fed's own projection of its federal funds rate by the end of 2024. In September, it saw this at 5.1%, implying a 0.25% cut in 2024. As of December, however, it now sees this at 4.6%, implying 0.75% in cuts in 2024. This was a monumental change for the Fed and a "green light" for the financial markets that the days of restrictive monetary policy are numbered. With respect to the Fed's balance sheet, assets were $7.713 trillion on December 27, down $98 billion from $7.811 trillion on November 22 (in-line with the Fed's commitment to reduce the balance sheet by $95 billion per month). The balance sheet peaked at $8.965 trillion in April 2022, so more than $1.2 trillion has been shaved off since then. The next FOMC announcement on monetary policy is scheduled for January 31. Overall, financial markets are now pricing in a soft landing with the expectation of easing monetary policy on the horizon (bullish for stock and bond prices).

Technical factors of the market are bullish (more demand than supply), while fundamentals are fairly priced – therefore, we are mildly bullish on the market. The Standard & Poor's forecast for S&P 500 operating earnings per share (EPS) through December 31, 2024 is $242.49, which implies a price-to-earnings (P/E) ratio of 19.7 with the S&P 500 at 4,770. The earnings yield (E/P) of 5.08% represents fair value relative to the 10-year U.S. Treasury note yield of 3.88%. The yield spread is 1.20%. The seven largest companies in the S&P 500 make up $12.0 trillion of the $42.0 trillion index market capitalization with a weighted P/E of 31.3. If 28.6% of the index has a P/E of 31.3, then 71.4% of the index has a P/E of 15.0 for the overall P/E to be 19.7. A P/E of 15.0 is an E/P of 6.66%, which is attractive compared to the 10-year Treasury note yield of 3.88% (a yield spread of 2.78%).

Equity markets jumped higher in December as bond yields plummeted, in anticipation of, and in response to, the Fed's dovish tone. The Fed gets credit for the bullish change in market sentiment in November, which carried forward into December. The S&P 500 did indeed punch through the July 2023 resistance level around 4,600 and moved within earshot of the all-time high of 4,796 from January 2022. In the short run, stock prices are clearly overbought. There is resistance on the S&P 500 around 4,800 from the all-time high. Above that, the sky is the limit. Should prices fall, there is plenty of support: 4,590 (July 2023 high), 4,503 (50-day moving average), and 4,354 (200-day moving average).

December saw an explosive outperformance by small cap and mid cap stocks, led by value. The following are total returns (including dividends) for the indexes in December (only one month): S&P 600 Small Cap Value +13.4%, S&P 600 Small Cap Growth +12.1%, S&P 400 Mid Cap Value +10.2%, S&P 400 Mid Cap Growth +7.4%, S&P 500 Large Cap Value +5.5%, and S&P 500 Large Cap Growth +3.7%. The fireworks displayed by small cap and mid cap stocks are positioned to continue into 2024 as the mega-cap technology stock bubble unwinds. Rather than try to time the popularity of a particular approach, it makes more sense to have a long-term focus on stocks of all market caps, emphasizing value.