Week in Review

Equity Markets:

The markets recovered last week with the S&P 500 ending up 1.87%, bringing its year-to-date return back in the green by 0.34%. The Dow Jones and NASDAQ had a strong week as well but are still negative on the year by 0.21% and 0.24% respectively. The S&P 500 closed Friday 0.7% below its all-time high which occurred over two years ago in January 2022. Large Cap Growth continues to outpace its value counterpart with the Russell 1000Growth currently holding a 1.46% spread above the Russell 1000 Value[1].

Friday saw a handful of major banks report earnings which marked the beginning of this quarter's earnings season. So far only 6% of companies have reported earnings but once again companies have proven more resilient than analysts predicted. 76% of S&P 500 companies have beaten earnings expectations[2]. The blended earnings growth rate, which takes current estimates and combines them with reported earnings, stands at -0.1%[2]. The large earnings misses from the financial sector have contributed to the early earnings decline.

Fixed Income Markets:

The bond market saw volatile trading towards the end of the week as mixed inflation reports were released. After rising as high as 4.07% on Thursday the 10-year Treasury yield fell 9 basis points on Friday to a close of 3.96%. The short end of the curve rallied last week with the 2-year Treasury yield dropping 0.26% for the week. The yield curve steepened significantly seeing the 2's/10's spread close to 0.17% to end the week at -0.18%.

The Fed Fund's Futures Market was active following the major inflation reports. Surprisingly, the futures market increased the number of expected cuts this year from 6 to 7. The futures market has a 39% probability of the Fed cutting rates 7 times this year, with the first coming in March[3]. The 37% probability is more than double what it was a week ago.

Economic:

Two major inflation reports were released last week. The first to be reported was the Consumer Price Index (CPI). For the month of December, CPI rose 0.3% and at an annual pace of 3.4%. Both of these were slightly above economists' estimates. Core CPI, which excludes food and energy, also rose 0.3% for the month and at an annualized pace of 3.9% which came in line with estimates. Housing remains a major contributor to inflation with shelter costs increasing 0.5% in December[4]. In a surprise report, the Producer Price Index (PPI), fell 0.1% in December and rose 1% from a year ago. Economists were expecting a monthly increase of 0.1%. Despite the stubborn readings, the inflationary environment has significantly improved but shows that it likely remains too early to claim victory on the inflation front.

Looking Ahead

Equity Markets:

2023 was a year marked by a rebound in sentiment and low market breadth where a few key constituents drove the majority of the market return and earnings. The Magnificent Seven are expected to see earnings growth of 39.5% for 2023 while the rest of the S&P 500 is expected to post a 2.6% decline in earnings[5]. The S&P 500 is currently trading at 19.6x forward four-quarter earnings. The "Mag 7" trades at much higher valuations of 30x[5]. The concentration in the market could lead to a subdued market if these handfuls of companies show any signs of weakness this earnings season.

Earnings reports continue to surprise to the upside but revenue numbers are showing weakness. So far, only 55% of S&P 500 companies are beating revenue estimates[2]. This is well below the long-term average of 62% and the past four-quarter average of 66.3%[6]. We believe there is a disconnect between earnings, revenues, and profit margins. The S&P 500 profit margin remains historically high and currently sits at 12%. With revenue expectations flat going forward we see potential challenges to see some of the high earnings expectations coming to fruition in the latter half of the year. The current environment does not lend itself to excess risk-taking outside of target allocations in our opinion. Keeping a long-term viewpoint and systematic rebalancing could help investors navigate future volatility while also seizing the opportunity to purchase assets that may be indiscriminately sold off with the rest of the market.

Fixed Income Market

The bond market has experienced large moves over the past 6 months. A selloff led to the 10-year Treasury pushing above 5% in October only to see yields collapse below 3.8% in December. We believe both of these moves were overdone and we are likely to settle into a steady range of 3.75%-4.25% in the near term. Despite significant improvement on the inflation front, we believe the market's expectation for 7 rate cuts this year is aggressive though. We see cuts coming this year but to see the Fed Funds Rate cut 150 to 175 basis points likely occurs if material economic weakness arises.

Our outlook remains positive on the bond market. Short bouts of volatility could arise due to knee-jerk reactions but investors should see these periods as opportunities to rebalance and secure attractive yields that exceed what was available during the last market cycle.

Economic:

The shortened week which will be highlighted by earnings reports is light on the economic calendar. Given the existing housing numbers on inflation, the Housing Starts report to be released on Thursday followed by Existing Home Sales on Friday will be key reports to keep an eye on. The retail sales report and the Preliminary University of Michigan Consumer Sentiment Index will be timely reads on the state of the consumer.

**** *See Important Disclosures on the following page*

Sources:

1)JP Morgan Asset Management
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2) FactSet Research Systems Inc.
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3)CME Group
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4) CNBC
https://www.cnbc.com/2024/01/11/cpi-inflation-report-december-2023-consumer-prices-rose-0point3percent-in-december-higher-than-expected-pushing-the-annual-rate-to-3point4percent.html

5)Reuters
https://www.reuters.com/markets/us/can-sizzling-magnificent-seven-trade-keep-powering-us-stocks-2024-2023-12-28/#:~:text=Another%20factor%20is%20profitability%3A%20the,albeit%20by%20a%20lesser%20extent.

6) LSEG I/B/E/S
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Important Disclosures: