James Investment Research, Inc.

Market Commentary

December 2023

This is an abbreviated version of our monthly market commentary highlighting recent events for November. You should expect our comprehensive 2024 outlook within the next two weeks.

Key Insights

• Stock Market Rebound: November witnessed a significant rebound in stock markets, with both small-cap stocks and larger stocks recovering.

• Bond Market Rally: The bond market followed the stock market's upward trend in November, fueled by easing inflation concerns.

• Potential for a "Soft Landing": The economy may be headed for a 'Soft-Landing', where it decelerates sufficiently to control inflation but avoids a recession.

Monthly Recap

The stock markets experienced a notable advance in November, despite facing challenges since the end of July. November marked a reversal from the correction that began on July 31 and culminated in the year's low on October 27. The Technology sector rallied by 12.2%, and the Consumer Discretionary sector also advanced by 11.0%, making them the two best-performing sectors of the month. In contrast, the Consumer Staples sector saw a modest gain of 3.9%, whereas the Energy sector experienced a slight increase of 0.3%.

Both small-cap stocks, represented by the Russell 2000 Index, and larger stocks, represented by the S&P 500 Index, rebounded, gaining 9.0% and 9.6%, respectively. However, year-to-date, larger stocks have yielded a return of 20.5%, while small-cap stocks have seen a modest increase of only 4.6%. This represents the widest margin since the late 1990s.

Most of the gains in the S&P 500 for November and year-to-date can be attributed to what are popularly known as the 'Magnificent 7' companies (Amazon, Apple, Google, Meta, Microsoft, Nvidia, and Tesla). The Bloomberg Magnificent 7 Total Return Index increased by 10.50% in November and by 97.2% year-to-date.

The growth style continued to outpace value in November, as the Russell 3000 Growth Index gained 10.4%, while the Russell 3000 Value Index gained only 8.0%.

Fortunately, the bond market, much like stocks, experienced a significant rebound in November. This improvement occurred as yields declined and worries about inflation subsided, leading to the U.S. Aggregate Bond Index rising by 4.5%. The U.S. Treasury market witnessed a rally across various maturities, with notable increases in prices, particularly for longer-duration bonds. The yield on the 10-Year U.S. Treasury notes consistently decreased throughout the month, dropping to 4.3% from 4.9% at the end of October. It is important to remember that as bond yields decrease, their prices increase.

The impressive financial markets' performance in November can likely be attributed to a mix of recent declines in both inflation and economic growth. This combination has raised the possibility that the Federal Reserve (Fed) might pause or conclude its current cycle of increasing interest rates. The growing belief that the most challenging phase of the Federal Reserve's rate hikes might be over could have significantly shifted market expectations.

Cooling Inflation Trends

The market continues to focus on inflation numbers. The year-over-year headline Consumer Price Index (CPI) inflation rate for October decreased to 3.2%, with core inflation softening to 4.0%. Furthermore, the Federal Reserve's favored measure of inflation, the Personal Consumption Expenditures (PCE) price Index, has been adjusted to show a 2.8% annual rate for the third quarter. When food and energy are excluded, this index has also been revised downward to 2.3%.

Although these numbers are still above the Federal Reserve's target of 2%, they represent a significant reduction from the June 2022 peak of 9.1%. This moderation in inflation rates came as a welcome development, particularly following the substantial rise in the Fed's "supercore" inflation, which is the services inflation excluding shelter costs, that had rattled the markets in September. In the coming months, it is anticipated that inflation rates for both shelter and services will trend downwards in the upcoming months.

Slowing Economy

The latest government update reveals that the Gross Domestic Product (GDP) grew at a revised rate of 5.2% annually in the third quarter. However, consumer spending increased at a slower rate of 3.6%. Looking ahead, Fitch Ratings has issued a caution that U.S. consumer spending may decelerate in 2024. This expected slowdown in spending is attributed to rising credit card interest rates and increased student loan payments, which could lead to higher household debt levels.

The unemployment rate rose slightly to 3.9%, reaching its highest level since January 2022. Concurrently, the U.S. economy added 150,000 jobs in October, falling short of the expected consensus estimates.

More Accomodating Fed

Over the past year, inflation has significantly declined, dropping from 7.15% at the end of October 2022 to 3.2% at the end of October 2023, while real GDP growth has picked up pace. This scenario, which contradicts the typically positive correlation between these two variables, reflects major improvements in supply chains. This is evidenced by the Federal Reserve Global Supply Chain Pressure Index (GSCPI), now in negative territory. Alongside these developments, there has been an overall improvement in labor supply and productivity.

This economic landscape offers the Federal Reserve a unique opportunity to control inflation while avoiding a downturn in the economy, especially in terms of preventing a rise in unemployment. This approach aims to achieve what is known as a 'soft-landing', where the economy slows down just enough to curb inflation without triggering a recession.

Conclusion

November marked a significant turnaround for the stock markets, which had been struggling since the end of July. Both small and large cap stocks witnessed rebounds. However, larger stocks have outperformed small-cap stocks year-to-date.

The bond market mirrored the stock market's positive trajectory in November, with yields declining and inflation concerns easing. The U.S. Treasury market experienced a rally across various maturities, notably with longer-duration bonds experiencing significant price increases.

This market optimism is largely attributed to the combined effect of declining inflation and slowing economic growth, raising the possibility of the Federal Reserve pausing or concluding its current cycle of rate hikes. The belief that the Fed's most aggressive phase of rate increases might be nearing its end has significantly altered market expectations.

This shift aligns with the recent cooling of inflation, and there is an expectation for continued decreases, especially in the sectors of shelter and services. Concurrently, the GDP growth rate

has picked up, yet consumer spending growth has slowed. This complex economic environment provides the Federal Reserve with the opportunity for a 'soft-landing,' effectively controlling inflation without triggering a recession. This strategy is supported by recent improvements in supply chains and labor market conditions, coupled with decelerating consumer consumption.

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