Janney

INVESTMENT PERSPECTIVES

JANUARY 2024

Key Takeaways —

- Pursuit of a soft landing continues in 2024.
- We anticipate volatile but trending bond markets in the new year—an extension of the 2023 experience.
- Strong market performance in December points to potential positive results for the year.

TOO MUCH OF A GOOD THING?

Mark Luschini, Chief Investment Strategist

Around the middle of last year, the consensus outlook for the economy shifted to discount the odds of a recession, and now many believe that a soft landing is the most likely outcome. This view was reinforced following the Federal Reserve's (the Fed) December policy meeting as the Summary of Economic Projections that accompanied the announcement of no new rate hike showed committee members have penciled in three cuts in 2024 amidst expectations of falling inflation and still positive economic growth.

It is worth asking, however, whether, in pursuit of a soft landing, could the Fed make a policy mistake by easing off its monetary restraint too soon? To be sure, everyone would opt for a soft economic landing if it could be guaranteed. But lacking that assurance one should consider the consequences if the effort fails and inflation stays high or even reaccelerates.

Indeed, it is good news that core inflation is coming down, but long-term inflation expectations remain elevated. Based on the monthly survey from the University of Michigan, consumers continue to hold their long-term inflation expectations above the pre-pandemic trend. Barring a major shock to inflation, such as a collapse in the price of oil, those expectations could very well stay elevated until price increases fall back to or below the Fed's target of 2% or a recession occurs. If the Fed cuts interest rates multiple times or moves toward market participants' expectations of four-six rate cuts, with the first as early as March, that might help avert a recession, but it would also likely keep the unemployment rate close to its current level.

With the current tight labor market fueling consumer spending, cutting rates too early or by too much risks stoking already elevated wage growth. Right now, the Atlanta Federal Reserve Bank's Wage Growth Tracker shows annualized wage growth of 5.2% for all workers, a level held for the last three months. Except for the wage spike in 2021-2022 induced by industries reopening in the aftermath of the COVID lockdowns, that pace is the quickest in more than 20 years. Should those wage gains remain elevated, it could feed back into core services inflation or unmoor long-term inflation expectations, complicating the Fed's reaction function.

The takeaway for investors is that the Fed's attempt to engineer a soft landing by cutting rates without having cooled the labor market sufficiently to douse demand could backfire if it caused a breakout in inflation or the long-term inflation expectations thereof. If so, that would necessitate the resumption of rate hikes, likely making the next recession more severe than our expectation of a mild-mannered version should one ensue this year.

For now, the Fed's policy shift is likely to support a bullish underpinning for stocks. A risk on modality is likely to prevail unless one or more of the following occurs: 1) The Fed aggressively pushes back against current market sentiment that multiple rate cuts will ensue shortly, 2) Actual core inflation begins to decelerate at a slower pace than what the Fed is forecasting, or leading indicators for inflation begin to signal a potential reacceleration, or 3) The economic data, particularly that associated with the labor market, turns unambiguously recessionary.

In sum, the complication in the soft-landing narrative that was primed by the December Fed meeting is that, while the odds have increased, so to have the odds of an overheating economy. That means that the Fed has set up asset prices for a potentially volatile year if it is forced to deliver a hawkish “surprise.” In our Outlook 2024 publication we postulated that the odds favored a modest and brief contraction in economic activity but overall, a favorable year for stocks. If evidence emerges that inflation and/or the labor market are deviating from the path projected by the soft landing, or mild recession scenarios, it may dictate a change in investment positioning. Stay tuned. ■

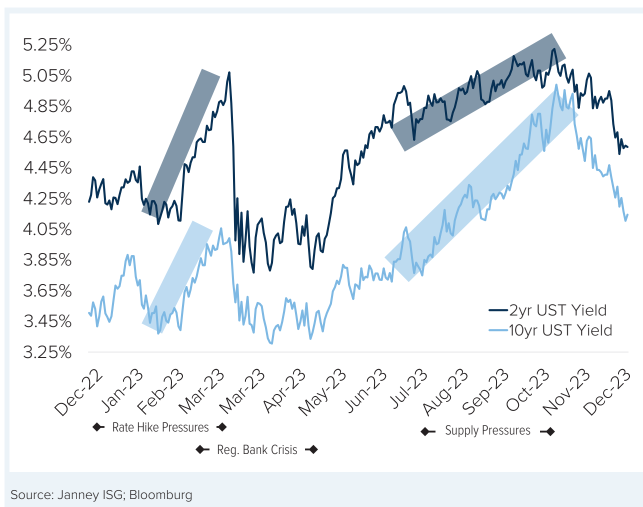
YEAR IN REVIEW

Guy LeBas, Chief Fixed Income Strategist

Once again, we are continuing our tradition in the fixed-income markets to take the first Investment Perspectives of the new year to reflect on major market themes from the prior year. The level of interest rates continues to be a significant driver of valuations across not just bond, but also stock and commodities markets—one need not look further than the nearest financial television program to figure out that much. Although this connection seems natural, the reality is that the impact of the level of interest rates on other financial markets varies considerably, and usually in proportion to the volatility of interest rates. As noted in Janney ISG's Outlook 2024, we anticipate volatile but trending bond markets in the new year, an extension of 2023's experience.

The primary market trend in 2023 was four distinct trading regimes, which felt almost seasonal. In winter, focus on further Fed rate hikes had yields rising rapidly. In spring, the regional banking crisis had yields falling for safety reasons. In late summer, U.S. Treasury supply pushed yields to their highest levels in more than a decade. And in late fall, those concerns faded abruptly. The net result was that interest rates ended the year violently unchanged. 10-year Treasuries ended at 3.88% after starting the year at 3.87%, marking the smallest change in interest rates in any year in contemporary history. Shorter-term interest rates actually fell, with two-year Treasuries ending at 4.25% after starting the year at 4.43%, the smallest change in short rates since 2016.

Chart 1: Interest Rate Markets Faced Multiple Selloff Regimes in 2023

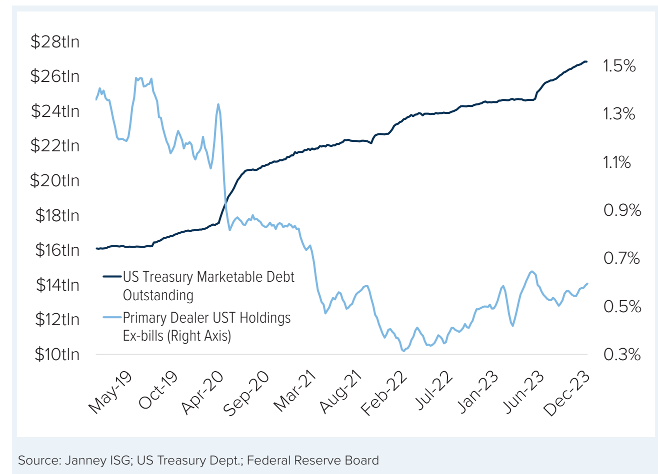


Source: Janney ISG; Bloomburg

Superlatives aside, the trending nature of interest rates through the four seasons was arguably the most instructive theme in 2023. Each of the four periods—Fed rising, banking falling, supply rising, and reversal—included not just a few days of buying or selling, but rather weeks and even months.

The persistent trends point to a structural issue within the U.S. bond, specifically, Treasury markets. In recent years, the U.S. Treasury has issued more bonds while the entities responsible for temporarily warehousing those bonds have reduced participation. Primary dealers' Treasury positioning, as a percentage of Treasuries outstanding, is about one-third the level it averaged pre-pandemic. A major shock absorber has essentially exited the bond markets, leaving those same markets more susceptible to trend-based buyers and sellers.

Chart 2: As Treasury Markets Have Grown, Dealers' Inventory Has Generally Shrunk, Leading to More Volatile Price Swings



Source: Janney ISG; US Treasury Dept.; Federal Reserve Board

In 2021 and again in 2022, one brand of trend-based traders experienced excellent returns. Commodity Trading Advisors, or CTAs, are rules-based funds that buy and sell (mostly) futures contracts in various liquid markets, including Treasury futures. Between good returns, which grew their capital, and a retreat of primary dealer "shock absorbers," CTAs grew in size and market influence. According to the CME, Treasury futures trading volume grew 16% in 2023 while Treasury debt increased by 8%, a further piece of evidence for CTA dominance. Most CTAs buy or sell using momentum signals, so they tend to support, rather than fight, a trending market.

Importantly, the CTA dominance is a structural market issue that only gets resolved if primary dealers step up their role in the markets, CTA capital shrinks following poor returns, or real money investors have an incentive to fight CTA trends. For 2024, there is no evident reason to expect any of these three resolutions. As a result, we expect trending interest rate markets for the new year as well. For now, the good news is that the longer the pattern persists, the easier it is to anticipate. Moreover, few market participants have come around to this trend/reversal view. Eventually, however, the trending pattern will become obvious, the market will adjust, and the rules will change once again.

HOPING FOR AN ENCORE

Gregory M. Drahuschak, Market Strategist

The stock market ended 2023 with a stunning two-month flourish that sent the S&P 500 to 3.26 points shy of its all-time intraday high and 15.32 points away from the closing high. The index posted its fourth-best November and the 15th-best December results since 1950. The S&P 500 gained more than 16% from the October low to set multiple 52-week highs.

Chart 3: CBOE 10-Year US Treasury Yield Index

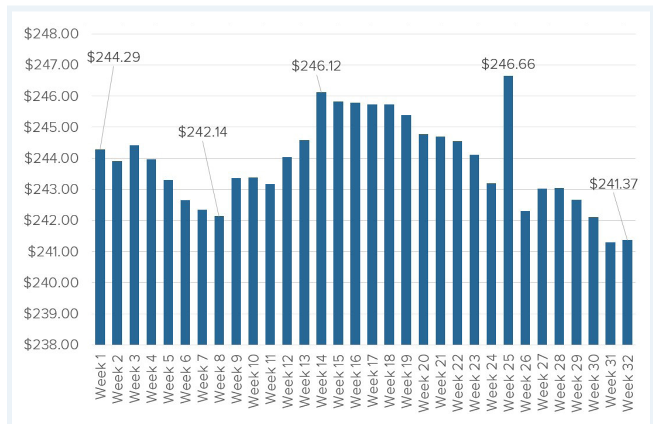
Source: Stockcharts.com

Equities were bolstered by falling interest rates that pulled the 10-year Treasury note rate from the 2023 high at 4.997% to as low as 3.785% by December 27, 2023.

The Federal Reserve Open Market Committee (FOMC) policy statement of December 13, 2023, reinforced thinking that credit tightening might be complete. There were very few changes in the December statement compared to the November version, but subtle alterations suggested a clear shift toward a dovish posture. The highly anticipated SEP (Summary of Economic Projections) showed the median 2024 rate expectation dropped to 4.6% from 5.1% in the September projection, which implied three interest rate cuts in 2024. The FOMC that day alone produced a 512.30-point gain in the Dow Jones Industrial Average as New York Stock Exchange breadth was roughly 7-1 positive. The market, however, could struggle if a series of rate cuts do not happen as anticipated.

Investors will keep a keen eye on 2024 earnings prospects. The current 2024 consensus earnings estimate has fallen in 10 of the last 14 weeks. Suggesting that 2024 earnings will rise more than 11% next year leaves little room for error. The flow of results for the final quarter of 2023 will intensify by the middle of this month. Be alert for companies offering advance indications of what they anticipate their 2024 earnings will be.

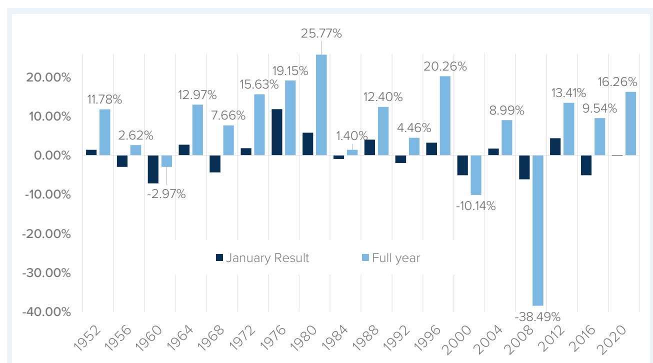
Chart 4: 2024 S&P 500 Earnings Estimate



Source: Thomson Financial; Janney Investment Strategy Group

The Republican caucus in Iowa on January 15, 2024, is the first of the presidential election events. An argument can be made that elections do not directly impact the overall stock market, but election rhetoric can influence trading at times during the year. It also can impact industries that might be affected by policy proposals. In the previous 18 presidential election years, the S&P 500 has ended the full year with a result less than what it produced in January only in 2000 and 2008, which were recession years. Since 1944, however, the S&P 500 was up every year when a sitting president ran for re-election.

Chart 4: S&P 500 January and Full-Year Results in Presidential Election Years 1952-2020



Source: Thomson Financial; Janney Investment Strategy Group

Strong market performance in December led to the hope that positive seasonal factors might again help the market in January. Chief among these was the Santa Claus rally period consisting of the final five days of one year and the first two of the next. Positive results in this period point to positive results for the year. Due to weakness in the first two days of January, for the first time in the last eight years, this

period did not end favorably. During just the first two days of 2024, the Technology, Discretionary, and Industrial sectors were down 3.57%, 2.79%, and 2.44%, respectively.

Chart 5: Santa Claus Rally Period

Source: Janney ISG

Negative results in the Santa Claus period do not necessarily lead to a negative number for the S&P 500 in the full year but rather to subpar annual results. However, positive results in the first week of January and the entire month of January typically bode well for the year. This has led to the phrase “as January goes, so goes the full year,” which has been accurate in 84% of all years, with major misses only 12 times in the prior 73 years.

The market’s strong performance in the final two months of 2023 was accomplished despite the S&P 500 facing a significant overbought condition. Momentum like the S&P had at the end of 2023 can trump technical factors for a time, but eventually, an extended technical condition can take at least a short-term toll. We have a positive view of market prospects for the year; however, technical factors suggest having a cautious approach to market activity early this year.

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