The Reed Colbert Perspective

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The New Year, the New Fed

Large cap stocks dominated the returns of the markets in 2023. S&P 500 index which is cap weighted meaning the large stocks make up a large portion of the index was up about 26% for 2023 and the Equal weighted S&P 500 index was up only around 12%. [1] And up until the end of the 3rd quarter, the equal weighted index was negative for the first 9 months. What this tells us is, unusually, the largest stocks grew the most last year and an unusual majority of the S&P500's positive returns were concentrated in only a handful of stocks. The average stock did not do so well. [2]

Investors continue to focus on the Federal reserve and interest rates moves. Very few focus on the quantitative tightening that is still going on as the Fed reduces their balance sheet and takes money out of the M2 Money supply. The Fed has mentioned they will start tapering their QT around June this year.[3] Since June 2022, as bonds mature on their balance sheet, they don't re-invest the money, keeping it and not putting it back into the economic money supply. This QT ultimately makes it harder for banks to loan and slows the economy.

What changed in the 4th quarter last year was the fed speak. Catching many investors off guard the Fed pivoted their discussion from higher rates for the foreseeable future to a more dovish sentiment, hinting towards rate cuts sooner than expected. Current consensus is a rate cut sometimes in the May/June time frame, and likely 75-100 bps cuts in total for the entire year 2024. [4]

Wage growth and unemployment are things to watch as those metrics may dictate more to what the Fed does than their own words. December wage growth has been strong, 5.2% according to the Atlanta fed Wage growth tracker.[5]

However, there is anecdotal evidence of wage growth slowing as of late, and there have been alerts for many companies about cutting workforce. I know it may sound counter-intuitive but job cuts and slowing wage growth is what is needed for a soft landing for the economy. If the economy continues to run hot, it will keep inflation high, nobody wants $10 gallon of milk. And I think the stock market would get spooked if the Fed started talking about raising rates more to fight inflation.

Notwithstanding, inflation seems to continue to moderate, as the real PCE index is at 2.6%[6], but inflation data can be lumpy, showing slowing one month and increases the next, what is important to watch is the longer-term trend, and currently that is down, which is why the Fed is now taking a breather on fighting it.

The real risk is if the Fed will get it wrong, investors are worried that they will keep rates too high too long, potentially sending us into a recession, or not fight inflation enough and we go into an economic tailspin. So far though, using all the tools in the Feds toolbox, it appears to me they are doing a decent job at a soft landing, trying to return the economy back to normal after a very unnormal pandemic and an extremely strong fiscal and government response to it.

Technical Indicators:

Just a quick note on stock market technicals. Momentum for the stock market is still very strong and this is typical for a late cycle bull market, where assets can go somewhat parabolic. At nearly 4900 when writing this and being the 5th day, the S&P 500 has made new highs, the path to 5200-5400 seems probable. But there is no debate that valuations in prices are getting stretched to above 20x earning[7]. There is still a lot of money in money markets earning high rates, but based on risk reward and where the rates may go soon, I would recommend a balanced approach. We expect a blended fixed income portfolio to return around 7% with not as much risk as stocks. But until stock momentum subsides, owning stocks still makes since as long as they have a headwind and an accommodating Fed.

Please reach out to our team if you have any questions about the information contained in this Newsletter.

1 https://wmrsi.webfarm.ms.com/pub/content/wmrsi/reports/marketing/wmir/s24_msg/89E16708-88CF-4787-B567-5280817A2773.html
2 Global Investment Committee Special Report: Consequences of Concentration (ms.com)
3 FOMC Preview: Annual
4 https://mssbcie.ms.com/ri/#lookup=7644e10e-6c21-11ee-a156-1e24d2d06b37;page=reportdetails
5 Wage Growth Tracker 5.2 Percent - Federal Reserve Bank of Atlanta (atlantafed.org)
6 Personal Consumption Expenditures Price Index | U.S. Bureau of Economic Analysis (BEA)
7 MS internal report, *Daily positioning Checking on Earnings and Valuations at Year-End*, Steve Edwards 1/3/2024.

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Disclaimers:

1 https://wmrsi.webfarm.ms.com/pub/content/wmrsi/reports/marketing/wmir/s24_msg/89E16708-88CF-4787-B567-5280817A2773.html
2 Global Investment Committee Special Report: Consequences of Concentration (ms.com)
3 FOMC Preview: Annual
4 https://mssbcie.ms.com/ri/#lookup=7644e10e-6c21-11ee-a156-1e24d2d06b37;page=reportdetails
5 Wage Growth Tracker 5.2 Percent - Federal Reserve Bank of Atlanta (atlantafed.org)
6 Personal Consumption Expenditures Price Index | U.S. Bureau of Economic Analysis (BEA)
7 MS internal report, *Daily positioning Checking on Earnings and Valuations at Year-End*, Steve Edwards 1/3/2024.