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Mitch on the Markets

Portfolio Manager Investing Insights

Is the Market Getting Enough 'Certainty' to Rally?

Markets don’t like uncertainty. And in the late summer and early fall, uncertainty is what the markets got.

In early August, the company Fitch Ratings lowered its rating on the U.S. to AA+, one notch down from the top AAA grade. The downgrade came nearly two months after a debt ceiling deal was struck – with worries about debt default gone – but the headline risk was enough to unsettle markets.[1]

Later in the month, news kept emerging from China that the world’s second-largest economy was in trouble, with a beleaguered property market, weak exports, and sagging consumer spending. Meanwhile, the global price of a barrel of crude oil kept climbing from July, rising over 20% in just a few weeks (likely because of weak China demand coupled with Saudi and Russian production cuts). Interest rates also made a significant move higher, with the 10-year U.S. Treasury bond climbing from 3.86% at the beginning of July to 4.88% by the end of October. Stocks sank as rates rose.

To top it all off, on October 7th, Hamas attacked Israel setting off a second war in addition to the Russia – Ukraine conflict. Markets were jittery as everyone wondered if the war would escalate into a regional conflict, involving other countries.

Uncertainty prevailed.

Looking ahead to the last few weeks of the year, however, I think markets are starting to see a clearer path forward, particularly in three areas that matter most: inflation, interest rates, and earnings. Below, I walk through each.

ABOUT MITCH ZACKS

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Mitch is the CEO & Senior Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

1. **Inflation and the Central Banks**

If we're reading between the lines, virtually every developed world central bank has indicated that they are done raising rates in this cycle. I say "reading between the lines" because no central bank has declared they're done – it's more about posturing/positioning while also keeping in mind economic data across each country.

At their most recent meetings, the Federal Reserve, the European Central Bank, and the Bank of England all left rates unchanged. In the U.S., with long rates pressured higher and the Fed no longer convinced that higher unemployment and weak economic growth are needed to pull inflation lower, all signs point to a long pause – perhaps followed by cuts sometime in 2024.

Inflation pressures continue to ease globally, and the likelihood of slower growth (see next point) should temper consumer spending (demand) enough to force corporations and small businesses to pull back on raising prices.

Why this all matters: when the Fed has finished hiking rates historically, stocks have performed well with the interest rate 'certainty' that comes with it. In the previous seven Fed hiking cycles, stocks and investment-grade bonds outperformed cash by 19% and 14%, respectively, over the following two years.

2. **Slowing Growth and Interest Rates**

Recent economic data in manufacturing, services, and even the labor markets have pointed to fading economic growth momentum – which investors should view as a positive. But the U.S. economy is also giving another signal of a potential 'soft landing' via gains in productivity.

The latest productivity print – which measures how much workers produce per hour – showed the biggest gain in three years. Unit labor costs also fell, which reduces a company's need to pass along rising costs through higher prices. This data suggests the businesses may be landing in some form of equilibrium – not too hot, not too cold – where growth moderates but can be maintained. As interest rates tend to respond to changes in growth rates and growth expectations, this data suggests upward pressure on rates could too be fading.

Bond markets received some other good news in November as well, when the U.S. Treasury said it plans to borrow less in Q4 than previously anticipated, while also indicating its intent to issue fewer longer-dated bonds. These developments arguably ease market worries about too much supply of new bonds, and provide additional 'certainty' on rates looking ahead.

3. **Earnings Turning a Corner**

With Q3 2023 earnings season behind us, we can say the overall earnings picture remains stable and largely positive. Earnings growth for the S&P 500 index, which was negative for each of the preceding three quarters, turned positive in Q3, even with a continued Energy drag. The earnings growth pace is expected to steadily improve in the coming periods – uncertainty turned to certainty.[2]

One factor to flag is that earnings estimates for Q4 have been coming down, as seen in the chart below. I would reframe this as a positive, however, as it makes exceeding earnings expectations in the final quarter of the year easier.

BOTTOM LINE FOR INVESTORS

With major central banks posturing to stop rate hikes, inflation still in a downtrend, upward pressure on interest rates easing as the economic growth shifts lower, and earnings growth turning a corner, I would argue that the market is seeing some 'uncertainty relief' as compared to summer and early fall. The geopolitical situation is still unsettling, but markets have already priced in the economic impact of both wars, in my view.

Looking ahead, if the U.S. economy experiences slower growth in Q4 while inflation ticks lower and the Fed stays on hold, I think markets will start looking much further ahead to an ongoing earnings recovery and the possibility of a rate cut on the horizon.

[1] J.P. Morgan. November 3, 2023. https://www.jpmorgan.com/insights/outlook/market-outlook/are-markets-finally-finding-direction

[2] Zacks. November 15, 2023. https://www.zacks.com/commentary/2184940/earnings-estimates-moving-lower-as-growth-moderates

Weekly Market Update

Important Market News We Think Worth Considering

Zacks
INVESTMENT MANAGEMENT

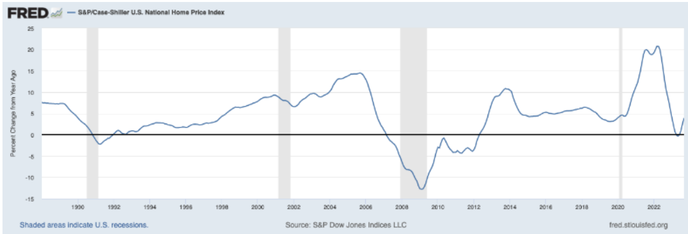
STEADY INVESTOR WEEK

- **Home prices hit new record in September**
- **The secret weapon in the labor market**
- **Hot button items on the tariff list this Christmas**

A Mixed Picture for the U.S Housing Market

Are prices for homes in the U.S. rising or falling? The answer depends on the type of home. Existing homes are feeling upward pressure on prices, as higher mortgage rates disincentivize would-be home sellers from moving—and giving up their low mortgage rate in the process. Existing home sales make up a majority of sales in the housing market, and in October they decreased 4.1% from September to a seasonally adjusted annual rate of 3.79 million, the lowest level since August 2010. With low national inventory and falling demand, prices are being pressured higher. The S&P CoreLogic Case-Shiller National Home Price Index rose 3.9% in September, compared to a 2.5% annual increase in August. As seen in the chart below, home prices can be volatile over time, but the post-pandemic surge means the starting point for rising prices today is very high.[1]

National Home Prices (% Change Year-Over-Year)



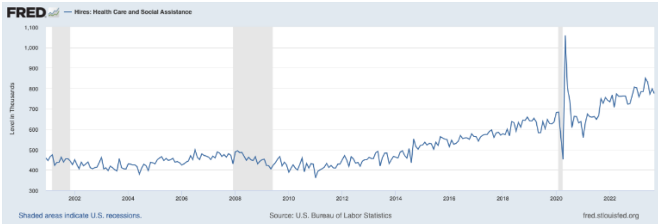
Source: Federal Reserve Bank of St. Louis[2]

But as mentioned at the outset of this story, not all home prices are rising. The median price of a new home fell nearly 18% in October from a year earlier, as builders have taken to building smaller homes while using incentives to keep prices down. New homes tend to be more expensive than existing homes, but at least the supply side of the equation is working in the buyer's favor.

The Secret Weapon in the Hot Labor Market: Healthcare Workers

We often write in this space about the strength of the labor market, with strong job growth for over two years and rising wages to boot. But one area of the economy in particular has been a key generator of jobs, even as other sectors, like technology, have been shedding jobs in recent months. That area is healthcare. Providers from hospitals to clinics to pharmacies and doctors' offices accounted for about one-third of all job gains in the last six months, even as the healthcare sector only makes up about 11% of the U.S.'s total workforce. As the baby boomer population ages, an increasing amount of healthcare workers will be needed to meet their needs and provide care, which suggests that the strong hiring trend in the healthcare sector could continue for years to come.[3]

Healthcare and Social Assistance – New Hires



Source: Federal Reserve Bank of St. Louis[4]

Hot Button Items on the Tariff List This Christmas

Back in 2018, the U.S. imposed tariffs on steel and aluminum from Europe, and the EU retaliated by implementing tariffs on a range of U.S. goods, from Levi's jeans to Harley Davidson motorcycles to orange juice. But one item in particular is facing a steep tariff starting on January 1, 2024, unless the U.S. and EU reach an agreement – whiskey. Each bottle shipped faces a 50% tax unless U.S. and EU officials hammer out a deal this month. The likely outcome for now appears to be that both parties will agree to delay the implementation of the tariff as negotiations continue, but in the words of Olof Gill, a European Commission spokesman, until the U.S. permanently removes the steel and aluminum tariffs, "the EU cannot permanently end its countermeasures."[5]

[1] Wall Street Journal. November 28, 2023. https://www.wsj.com/economy/housing/home-prices-rose-to-record-in-september-0203b125

[2] Fred Economic Data. November 28, 2023. https://fred.stlouisfed.org/series/CSUSHPINSA#

[3] Wall Street Journal. November 24, 2023. https://www.wsj.com/economy/jobs/hot-healthcare-hiring-bolsters-cooling-u-s-labor-market-336a7b27?mod=djemRTE_h

[4] Fred Economic Data. November 1, 2023. https://fred.stlouisfed.org/series/JTS6200HIL#

[5] Wall Street Journal. November 27, 2023. https://www.wsj.com/economy/trade/u-s-whiskey-is-collateral-damage-in-trans-atlantic-trade-fight-688541bc

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