

Monthly market update

The implications of a long landing | February 2024

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Key takeaways

- There is broad consensus for a soft landing in 2024. While this may be the most likely scenario, the size and timing of Fed rate cuts is still uncertain.
- Markets have priced in a large number of rate cuts over the past few months. This has driven a strong equity rally, pushing valuations higher.
- Fixed income could also face headwinds if rates stay somewhat higher for longer across the yield curve.

Market update

The consensus in markets is that a soft landing will be achieved in 2024. Inflation has slowed across all measures, the economy is growing steadily based on the latest GDP reports and the labor market remains historically strong. These trends have driven markets higher over the past year, with the S&P 500 and Dow reaching new record highs recently. For many investors and economists, the current market and economic environment represents the best-case scenario that could have been hoped for just a year ago.

However, there is still much uncertainty around the path of Fed rate cuts and economic growth. While the Fed's own projections suggest there might be three rate cuts this year, as shown in the accompanying chart, markets are still anticipating at least five, most likely beginning with the FOMC announcement on May 1. The Fed also communicated at its January announcement that it needs "greater confidence" that inflation is improving, and is thus unlikely to begin cutting rates in March.

One component of these rate cut expectations is that the economy is expected to slow from the robust pace experienced in the second half of 2023. Recent data have been mixed, with the January jobs report far exceeding expectations; 353,000 jobs were added and unemployment hovered at only 3.7%, suggesting that many parts of the economy are still robust. Altogether, this

creates a challenging situation for the Fed and investors who must use judgment to determine the right timing and size of policy moves.

Exhibit 1

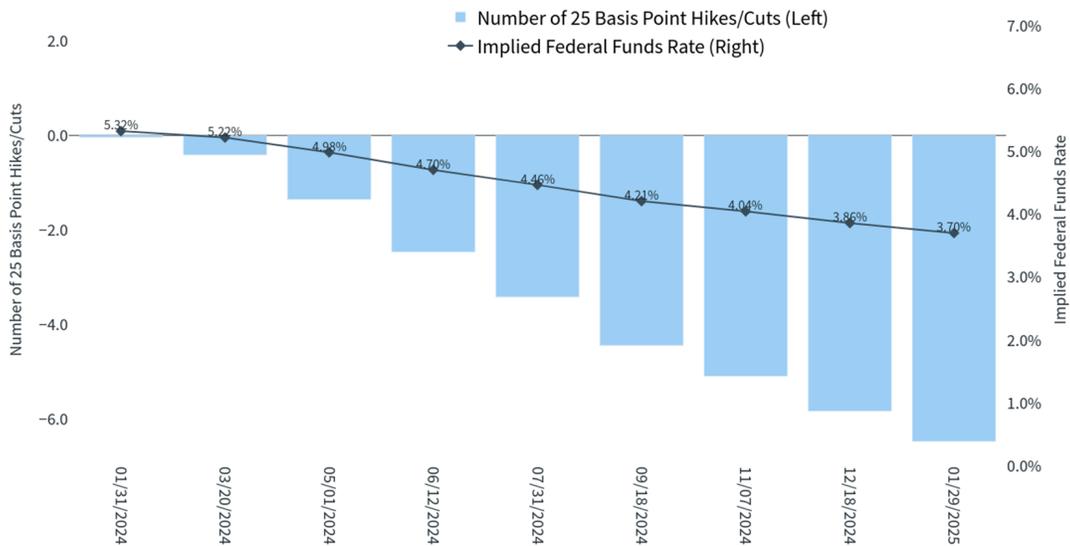
The Fed's summary of economic projections point to three rate cuts in 2024

Market and Economic Chartbook | February 2, 2024



Fed Funds Futures Implied Rates

Implied fed funds rates and number of hikes/cuts at each Fed meeting



Sources: Clearnomics, Bloomberg
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Sources: Clearnomics, Federal Reserve

Given the macroeconomic backdrop, the soft landing that is widely anticipated may be more aptly characterized as a long landing. The Fed may need to utilize every inch of runway to achieve its policy goals, especially because they may be hesitant to declare victory prematurely. Even once inflation is trending toward the Fed's 2% target, they may prefer to keep rates tighter for longer to prevent a resurgence of price pressures, such as those that occurred throughout the 1970s and early 1980s. Inflation components such as energy, for instance, have been known to reverse quickly if oil and gas prices spike.

What does this mean for asset allocation decisions? For equities, slower or fewer rate cuts may mean that market expectations are too lofty after the rally at the end of 2023. Too high a probability of a soft landing and a return to a “normal” economic environment are priced into markets. The S&P 500 price-to-earnings ratio, for instance, is hovering around 20 times next-twelve-month earnings, as shown in the chart below. In fact, because earnings are expected to have been flat in 2023, the S&P 500’s 26.3% total return in 2023 can be attributed entirely to rising valuations.

Additionally, these gains were driven heavily by technology and artificial intelligence-related stocks, including the so-called Magnificent Seven. There are early signs that other sectors are beginning to benefit from an improving economic and rate environment, but this may take longer to materialize. Financials and Industrials, for instance, both notched double-digit total returns last year, and Financials have been one of the better performing sectors so far this year.

Exhibit 2

Valuations suggest that investors have high expectations for markets



Sources: Clearnomics, Standard & Poor’s, LSEG

For fixed income, rates that are somewhat higher for longer may continue to be a headwind. Indeed, longer-term rates have been uncertain this year, with the 10-year U.S. Treasury yield climbing briefly to 4.18% in January before declining below 4% again. A more stable rate outlook would make these rates more attractive to long-term investors, especially if they expect inflation to decline. The fact that most bond sectors are offering significantly higher yields than at any other time over the past decade, including across Treasuries, MBS and investment grade corporate bonds, means that they can serve important roles in many portfolios.

Significant market and economic uncertainty remains as the Fed prepares to cut rates after one of the fastest rate hike cycles in history. While consensus has coalesced around a soft landing in 2024, investors should remain cautious about the timing and size of policy easing. Expectations for both equities and fixed income may be too lofty and may require more careful risk management in the year to come.

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