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Wealth Advisory Market Update

January 8, 2024

Equities

The Market, measured by the S&P 500 index, rose 4.4% for the month of December. The S&P 500 finished the year on a nine week win streak, the longest streak since 2004. The index was up 24.2% for the year. Much of this performance occurred in the last two months which was attributed to a drop in bond yields, a dovish Fed press conference, and increased confidence in a soft landing. However, the main drivers of the move were actually the easing of financial conditions and the liquidity in the system, as a result of the record deficits the US is running. Financial conditions eased throughout the year, back to where they were in January of 2022. This means that all of the tightening by the Federal Reserve in the form of rate hikes was undone over the course of 2023.

While many have been optimistic about the outlook for the economy, hard data continues to show otherwise. The manufacturing sector continues to slow. December data showed the slowdown in that sector has now spread to the labor market. In the fourth quarter, factories lowered employment to a level last seen in 2009, excluding the pandemic. We are also continuing to see prices rise while orders continue to slowdown, indicating signs of stagflation.

We head into 2024 cautiously, with the equity markets having moved higher throughout the year due to growth in multiples, and not fundamentals. With signs of an economic slowdown still flashing yellow, a more defensive approach has historically performed well relative to the market. That is why we are positioned with companies that have inelastic demand, strong balance sheets, and steadily increasing cash flows. We have increased our weightings in Health care and Utilities over the last few months, positioning for a tougher economic environment.

Economic Indicators and Monetary Policy

The strength of headwinds facing the consumer continues to rise. Data from the resumption of student loan payments show that 9 million, or 40%, of student loan borrowers defaulted on their first payment in October. Consumer debt continues to hit record highs as the average consumer continues to struggle with inflationary pressures. While consumer spending has kept the economy afloat and out of a recession so far, this is another sign that current spending is not sustainable. Earnings calls from retailers mention that consumer spending is slowing down and that consumers have become more deal conscious. FedEx, a bellwether for the consumer, issued negative guidance about demand. Increased Buy Now, Pay Later shopping, 401k hardship withdrawals, as well as credit card delinquencies, do not paint a picture of a healthy consumer. Employment numbers have also become concerning. Eleven of the last twelve payroll numbers have been revised lower. The latest jobs report beat the expected number but was ugly underneath. The report showed the US lost 1.5 million full time jobs in the month of December, while multiple-jobs holders hit an all-time high. The market reacted positively to the headline number, but it faded when the internals showed how ugly the report really was.

Geopolitical risks continue to be heightened as the fighting in Gaza intensifies. A new development has risen in the Red Sea, as Iran-backed rebels have begun attacking container ships. As a result, trade has been disrupted with major players, such as Maersk, avoiding routes through the waterway. This is causing a major uptick in supply chain shipping rates, along with the time it takes to move goods. A major disruption in supply chains inevitably leads to higher prices (i.e., inflation). The longer this goes on and the more these tensions rise, the bigger the impact this will have on the global economy.

The Federal Open Market Committee (FOMC) decided to keep rates steady at their December meeting, a decision that was widely expected. However, it was their Summary of Economic Projections that ignited a rally for the market, as well as Chairman Jerome Powell's remarks. The Fed's dot plot forecasted three quarter point cuts for next year, something the market had been hoping to see. Powell's press conference following the release was a dovish one. While he expressed that inflation remains too high and that ongoing progress is unknown, he did appear to be content with where things are going. For example, he mentioned that growth is moderating, labor markets are coming into better balance, and core inflation is showing real progress; all things they wanted to see.

While the Fed appears to have reached the peak of their tightening cycle, and will look to cut in the New Year, we believe it is the result of overtightening. Meaning they raised rates too high too fast. It is our view that the Fed is seeing some concerning signs that the economy is not as strong as many believe. The Fed will likely look to cut rates in order to avoid the "hard landing" that signs in the economy are signaling. We mentioned a few months ago that we thought the next move in rates would be down not up. This was out of consensus at the time, but in our opinion the underlying economy was a lot worse than what headline numbers were showing. This is now the base case for the FOMC. Historically, markets struggle, not when the Federal Reserve is raising rates but, when they begin to cut.

Strategy

With signs of a recession increasing, it highlights the importance of having a defensive strategy. Historically, during economic downturns, companies with significant market capitalization, pricing leverage, and inelastic demand tend to exhibit strong performance. In the fixed-income space, yields continue to fall while prices respond inversely. We extended the duration of our portfolios throughout the year taking advantage of higher rates. However, with interest rates crashing over the last few months, we are pausing this approach. Our primary focus in the fixed income sector remains high-quality credits that offer proper compensation for the underlying risk.

As we navigate this challenging environment, we appreciate your support and the opportunity to collaborate with you in achieving your financial goals.

Matthew J. Roach, CFA®
Chief Investment Strategist

Mike Servetas
Assistant Portfolio Manager