Market analysis

November 6, 2023

At a glance
The Federal Reserve held interest rates steady last week, a move cheered by equity markets hoping rate hikes were done. Softening in the U.S. labor market and weaker purchasing manager surveys supported the view the Fed may not require additional rate hikes for inflation to continue to slow.

Number of the week
4.1%

The growth in U.S. wages over the past year through October, the slowest pace since mid-2021.

Term of the week
Labor force participation rate – An estimate of the economy’s active workforce. The formula is the number of people ages 16 and older who are employed or actively seeking employment, divided by the total noninstitutionalized, civilian working-age population.

“The U.S. job market appears to be slowing modestly, with the auto strike adding to the slowdown. Non-farm payrolls added just 150,000 jobs in October, with a 35,000-worker decline in manufacturing employment, largely reflecting striking auto workers. In addition, revisions dragged August and September payrolls down by 100,000 jobs, with the past three months now averaging gains of 204,000 per month. The unemployment rate rose 0.1% to 3.9%, and the household survey indicated weaker employment and labor force participation.”

- Robert Haworth, CFA, Senior Vice President, Senior Investment Strategy Director, U.S. Bank

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[1] Important disclosures provided on page 4
Global economy

Quick take: The U.S. labor market appears to be softening as the Federal Reserve (Fed) holds interest rates higher. Global purchasing manager surveys point to still-slowing activity, especially in manufacturing.

Our view: The global economy continues to shrug off elevated inflation and rising interest rates, though growth is likely to moderate into year-end. Despite higher interest rates, the U.S. Bank Economic Team sees conditions consistent with a soft landing in the U.S.

- **The U.S. job market appears to be slowing modestly**, with the auto strike adding to the slowdown. Non-farm payrolls added just 150,000 jobs in October, with a 35,000-worker decline in manufacturing employment, largely reflecting striking auto workers. In addition, revisions dragged August and September payrolls down by 100,000 jobs, with the past three months now averaging gains of 204,000 per month. The unemployment rate rose 0.1% to 3.9%, and the household survey indicated weaker employment and labor force participation. Wage growth also slowed, rising just 4.1% for the past year, the slowest pace since mid-2021. The weaker job market is likely dampening consumer confidence — the October Conference Board Consumer Confidence Index slipped to its lowest level since May, and 70% of consumers believe a recession is somewhat likely in the next 12 months.

- **Purchasing manager surveys indicate slowing activity for both manufacturing and services sectors.** The Institute of Supply Management Manufacturing Index dropped further into recessionary territory in October, with declines in employment, new orders and inventories. The services index indicated slowing growth, with slowdowns in employment and inventories, though gains in new orders kept the index positive.

- **European growth continues to falter** but has avoided a technical recession. Third quarter gross domestic product fell 0.1% after posting slight gains in the first half of the year. Compared to a year ago, the growth rate in Europe slowed to just 0.1% from 0.5% last quarter. Slower growth is helping trim inflation; consumer prices rose just 2.9% over the past year through October, down from 4.3% through September.

- **Manufacturing dipped in S&P Global Purchasing Manager Indexes around much of the world in October.** Europe remains the primary drag, and slowdowns in China and Japan offset strength in India. Much of the weakness was in industrial goods, while consumer goods production rose at the fastest pace in five months. On balance, manufacturers appear cautious about the future — the employment component of the survey dropped for the second consecutive month and to the lowest level since August 2020.

Equity markets

Quick take: U.S. equities trended higher last week. Sentiment for equities appears to be improving on the heels of declining bond yields and indications of moderating economic growth.

Our view: Persistent inflation, elevated interest rates and uncertainty over the pace of earnings growth in 2023 and 2024 have remained headwinds to advancing equity prices for much of 2023. Still to be determined is whether the pace of inflation is on a sustained downtrend, which would pave the way for the Federal Reserve to take a more dovish stance on interest rates.

- **Recent performance reflects a near-term risk-on (more aggressive) bias.** The S&P 500 was up 3.9% in the first three trading days of November, with all 11 S&P 500 sectors posting gains that range from 1.3% to 6.1%. This is a noteworthy turnaround from the -2.2% return of the S&P 500 in October, when 10 of the 11 S&P 500 sectors posted loses. As of Friday’s close, the S&P 500 is up a robust 13.5% year to date. However, market breadth remains narrow; broad market strength is bolstered by three sectors (Communication Services, Consumer Discretionary and Information Technology), which are up between 26.2% and 42.4% for the year; six of 11 S&P 500 sectors are negative.

- **Third quarter corporate results are trending modestly above muted expectations.** As of Friday’s close, 81% of S&P 500 companies have released quarterly results. Sales and earnings are advancing 2.0% and 2.8%, respectively, over year-ago levels, both modestly above expectations, according to Bloomberg. In recent days, several companies have noted a slowing pace of consumer spending, particularly among lower income groups. This increases uncertainty over spending levels in the fast-approaching holiday spending season.

- **Earnings projections for 2023 and 2024 remain largely unchanged, with downside bias.** Consensus expectations for earnings in 2023 and 2024 — approximately $220 and $244, respectively, according to Bloomberg, FactSet and S&P Cap IQ — have remained relatively stable, but with the 2024 estimate inching lower. As of Friday’s close, the S&P 500 trades at respective 19.8 and 17.8 times projected 2023 and 2024 estimates, in line with recent 25-year historical averages.
**Bond markets**

Quick take: Ten-year Treasury yields fell more than 0.3% last week to just below 4.6%, well off their recent highs near 5.0%. Investors speculated the Fed has reached the end of its rate hiking campaign.

Our view: Normal bond exposures that primarily consist of high-quality bonds typically help offset equity risk with the Fed nearing the end of rate hiking cycles. Yield volatility persists, suggesting that neutral interest rate sensitivity (duration) versus benchmarks remains appropriate.

- The Fed maintained interest rates in a range of 5.25% to 5.50% for the second meeting in a row. The Fed recognized the tightening of financial conditions stemming from the increase in long-term yields since its last meeting should help bring inflation down to its 2% target. However, Chairman Jerome Powell noted the rise in long-term yields needs to be persistent to qualify as sufficient tightening that reduces the need for rate hikes. Powell emphasized interest rate decisions will be made on a meeting-by-meeting basis in response to changes in economic conditions. Accordingly, bond yields fell following the soft labor market data released Friday. Market interest rates indicate a likelihood that the Fed will hold rates steady for the next one to two quarters before embarking on a series of rate cuts that bring the federal funds rate down to a range of 4.25% to 4.50% by the end of 2024. The Fed’s recognition that there is still "a long way to go" to cool inflation to 2% introduces uncertainty around the market’s expectation of four 0.25% rate cuts in 2024. Treasury issuance bears watching; rising issuance remains necessary to fund deficit spending. Last week, the U.S. Treasury Department released its issuance forecasts for coming quarters that indicated a smaller increase than many expected, boosting Treasury bond prices and placing downward pressure on yields.

- The potential conclusion of the Fed’s hiking cycle boosted investor optimism, fueling riskier bond outperformance. Corporate and municipal bond prices rose last week as their incremental yield spread over Treasuries declined. High yield corporate and municipal bond valuations are normal to slightly expensive relative to historical averages, but they offer significant yields. Riskier bond prices remain sensitive to the outlook for monetary policy, a potential risk should the Fed stick with its plan to maintain high borrowing costs for longer.

**Real assets**

Quick take: Real Estate stocks moved higher last week, driven by large declines in interest rates. All Real Estate sub-sectors outperformed the broader market. Oil prices lagged, with the Hamas-Israel conflict remaining contained.

Our view: We continue to see value in real assets’ defensive sectors. We favor tangible assets with stable cash flows as the market moves into a period likely plagued by decelerating economic growth and corporate earnings. Commodities remain vulnerable if expectations for falling inflation and decelerating growth come to fruition.

- Real Estate outperformed the S&P 500 by 2.7% last week. Offices were the top-performing properties, beating the broader market by 6.5%. Residential properties lagged, but still beat the S&P 500 by 1.2%. Public real estate trades at a discount to the underlying net asset values of their properties, but upward trending interest rates and slowing economic indicators pose further risks.

- Infrastructure traded in line with the S&P 500 last week. Airports led performance, beating the broader market by 2.3%. Toll roads, the worst-performing sector, trailed the broader market by 1.9%.

- Crude oil prices fell 5.9% last week despite the continuing conflict in Gaza. We see the crude market as undersupplied over a longer time horizon, which should be supportive for prices. However, we acknowledge downside exists if a solution to the crisis in Gaza is found or economic growth disappoints.
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