Market analysis

December 4, 2023

At a glance

Market hopes of Federal Reserve rate cuts in 2024 buoyed returns for both bonds and stocks last week. Recent inflation data continues to modestly slow despite strong third quarter U.S. economic growth.

Number of the week

4.5%

The increase in earnings of S&P 500 companies in 2023's third quarter compared to a year earlier. Analysts expected a 0.1% increase.

Term of the week

Earnings reporting period – Public companies are required to file quarterly earnings reports that include revenue, profit, operational expenses and cash flow. The reports also generally inform investors of challenges and opportunities from the viewpoint of management (guidance).

> "The U.S. Bureau of Economic Analysis adjusted the third quarter gross domestic product higher in its second update to 5.2% annualized on revisions upward to investments and government spending and downward to consumer spending. October data for personal income and spending are much slower than the averages during the third quarter. Manufacturing purchasing manager surveys from the Institute for Supply Management and S&P Global indicate an ongoing contraction in business activity in November."
>
> \- **Robert Haworth, CFA,** Senior Vice President, Senior Investment Strategy Director, U.S. Bank

usbank.com

Investment products and services are:

NOT A DEPOSIT • NOT FDIC INSURED • MAY LOSE VALUE • NOT BANK GUARANTEED • NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY

[1] Important disclosures provided on page 4.

Global economy

Quick take: U.S. economic activity appears to be slowing in the fourth quarter after a robust third quarter, but inflation is also abating. Outside the U.S., global manufacturing activity appears weak, with India and Mexico two key exceptions.

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 third quarter was strong for the U.S. economy, but early economic data for the fourth quarter is softer**. The U.S. Bureau of Economic Analysis adjusted the third quarter gross domestic product higher in its second update to 5.2% annualized on revisions upward to investments and government spending and downward to consumer spending. October data for personal income and spending is much slower than the averages during the third quarter. Manufacturing purchasing manager surveys from the Institute for Supply Management and S&P Global indicated an ongoing contraction in business activity in November.
- **Global inflation data continues its slowing path in the wake of interest rate hikes by the Federal Reserve (Fed) and other global central banks.** The U.S. Personal Consumption Expenditure Price Index slowed to a 3.0% year-over-year gain in October, down from 3.7% in September. Weakness in energy prices helped, as did declines in durable goods prices. In the Eurozone, the early estimate of the November Consumer Price Index slowed to 2.4% over the past year from 2.9% in October, the slowest pace in more than two years, with lower energy prices the primary driver.
- **Global manufacturing purchasing manager surveys for November still tilt toward contraction**, with developed market economies including the Eurozone, the United Kingdom and Japan leading the declines, though the pace of decline in Europe appears to be moderating. Data for China was slightly better, but closer to neutral than growth. India and Mexico continue to lead emerging economic manufacturing activity, improving over October.

Equity markets

Quick take: U.S. equities posted strong performance in November on the heels of modestly better-than-expected third quarter results.

Our view: Inflation, interest rates and the pace of earnings growth in 2023 and 2024 remain headwinds to advancing equity prices. 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 toward interest rates.

- **November performance was strong across indices and sectors.** The popular broad-based U.S. indices advanced between 8.8% and 10.7% in November, with 10 of 11 S&P 500 sectors posting gains. The Consumer Discretionary, Financials, Information Technology and Real Estate sectors all were up 10% or more. Energy was the only sector in negative territory, retreating 1.6%. Broad-based performance strength across indices and sectors is one indicator of a market that may be poised to grind higher.
- **Third quarter corporate results modestly exceeded expectations.** The third reporting period is effectively over, with 98% of S&P 500 companies having released results. Sales and earnings advanced 1.8% and 4.5%, respectively, over a year ago, modestly above expectations for sales to increase 1.5% and earnings to increase 0.1%. Better-than-expected earnings are helping provide valuation support.
- **Third quarter reporting takeaways are largely positive.** Money center banks report consumer and business balance sheets are in relatively good shape, capital ratios are improving and deposit trends are stable. Consumers continue to spend on experiences, while spending on durables remains muted; spending among those in affluent and middle-income tiers is stable, but spending among lower-income consumers is slowing. While early, holiday spending is exceeding expectations. Similarly, the pace of technology spending by businesses remains constructive. Expense control remains tight, helping support profit margins and earnings. However, guidance for 2024 remains limited, which implies uncertainty following the release of fourth quarter results beginning in mid-January.

Bond markets

Quick take: Treasury yields dropped last week, driving strong gains across the bond market, despite an effort by Fed Chairman Jerome Powell to highlight the possibility that further policy tightening may be appropriate.

Our view: Investor optimism of multiple interest rate cuts in 2024 introduces the potential for ongoing yield volatility if officials more forcefully offer guidance for maintaining current policy settings.

- **Fed representatives seek evidence inflation is returning to 2% before committing to easier rate policy.** Yields fell early in the week in reaction to Fed Governor Christopher Waller's comment that the Fed could reduce rates in coming months to keep pace with a potential slowdown in inflation. However, other Fed officials took a more balanced view. New York Fed President John Williams said he expects to maintain currently restrictive policy settings for some time. Richmond Fed President Thomas Barkin said he wants the option to raise rates if inflation flares up again, and Fed Governor Michelle Bowman said she would support raising rates if progress on inflation stalls. The need for additional data before deciding on a path forward for rate policy emerged as a key theme in Fed comments last week. Powell cemented this point on Friday, indicating it's premature to conclude that policy is sufficiently restrictive. Despite this effort to push against increasingly aggressive market pricing of policy easing, yields fell Friday on expectations of more rate cuts. Entering last week, market prices were based on 0.75% to 1.00% in rate cuts in 2024. Now, the expectation is 1.25% to 1.50% in rate cuts.
- **Expectations for easier monetary policy extended the rally in riskier bonds.** The incremental yield over Treasuries on corporate and municipal bonds, referred to as spreads, declined last week. This extra yield spread compensates investors for credit risk, and spreads are now below long-term averages across both high-quality and riskier high-yield corporate and municipal bonds. The yields available on corporate and municipal bonds are still attractive, considering most bond yields are still well above their highs from the last decade, but higher valuations on riskier bonds offer less incentive to increase credit risk. We prefer normal allocations in fixed income that are primarily comprised of high-quality bonds, but with modest exposures to riskier high yield bonds that can improve total return potential in portfolios.

Real assets

Quick take: The dramatic decline of market interest rates over the past two months has spurred performance of dividend-producing real assets. Real Estate is the second-best performing sector in the S&P 500 so far in the fourth quarter, trailing only Technology. Similarly, Infrastructure has traded in line with the broader market during the quarter after lagging the market for much of 2023.

Our view: We continue to see value in real assets' defensive sectors. We favor tangible assets with stable cash flows as the market moves through 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 4.2% last week**. Offices were the top-performing properties, beating the broader market by 13%. Data centers were the worst performers but still beat the broader market by 0.7%. We believe public real estate offers compelling value relative to private real estate prices, but a slowing economy and tightening credit conditions remain headwinds.
- **Infrastructure beat the S&P 500 by 1% last week**. Railroads led performance, beating beat the broader market by 2.6%. Toll roads lagged but outperformed the S&P 500 by 0.2%.
- **Crude oil prices fell 3.5% last week** after OPEC+ (the Organization of the Petroleum Exporting Countries and 10 oil-producing allies, including Russia) agreed to voluntary production cuts that investors hoped would go deeper. In the near term, the market appears oversupplied; domestic crude oil inventory has increased for six consecutive weeks. Over a longer horizon, we see the crude market as undersupplied, which should be supportive for prices.

This information represents the opinion of U.S. Bank. The views are subject to change at any time based on market or other conditions and are current as of the date indicated on the materials. This is not intended to be a forecast of future events or guarantee of future results. It is not intended to provide specific advice or to be construed as an offering of securities or recommendation to invest. Not for use as a primary basis of investment decisions. Not to be construed to meet the needs of any particular investor. Not a representation or solicitation or an offer to sell/buy any security. Investors should consult with their investment professional for advice concerning their particular situation. The factual information provided has been obtained from sources believed to be reliable but is not guaranteed as to accuracy or completeness. U.S. Bank is not affiliated or associated with any organizations mentioned.

Based on our strategic approach to creating diversified portfolios, guidelines are in place concerning the construction of portfolios and how investments should be allocated to specific asset classes based on client goals, objectives and tolerance for risk. Not all recommended asset classes will be suitable for every portfolio. Diversification and asset allocation do not guarantee returns or protect against losses.

Past performance is no guarantee of future results. All performance data, while obtained from sources deemed to be reliable, are not guaranteed for accuracy. Indexes shown are unmanaged and are not available for direct investment. The **S&P 500 Index** consists of 500 widely traded stocks that are considered to represent the performance of the U.S. stock market in general. The **Institute of Supply Management Manufacturing Index**, also called the Purchasing Manager's Index, measures manufacturing activity based on a monthly survey, conducted by the Institute for Supply Management, of purchasing managers at more than 300 manufacturing firms. The **S&P Global Purchasing Managers' Index** data are compiled by IHS Markit for more than 40 economies worldwide. The monthly data are derived from surveys of senior executives at private sector companies. The **Personal Consumption Expenditures (PCE) Price Index** is a measure of the prices that people living in the United States, or those buying on their behalf, pay for goods and services. It is known for capturing inflation (or deflation) across a wide range of consumer expenses and reflecting changes in consumer behavior. The **Consumer Price Index** is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. It is one of the most frequently used statistics for identifying periods of inflation or deflation.

Equity securities are subject to stock market fluctuations that occur in response to economic and business developments. **International investing** involves special risks, including foreign taxation, currency risks, risks associated with possible differences in financial standards and other risks associated with future political and economic developments. Investing in **emerging markets** may involve greater risks than investing in more developed countries. In addition, concentration of investments in a single region may result in greater volatility. Investing in **fixed income securities** are subject to various risks, including changes in interest rates, credit quality, market valuations, liquidity, prepayments, early redemption, corporate events, tax ramifications and other factors. Investment in debt securities typically decrease in value when interest rates rise. This risk is usually greater for longer-term debt securities. Investments in lower-rated and non-rated securities present a greater risk of loss to principal and interest than higher-rated securities. Investments in **high yield bonds** offer the potential for high current income and attractive total return but involve certain risks. Changes in economic conditions or other circumstances may adversely affect a bond issuer's ability to make principal and interest payments. The **municipal bond market** is volatile and can be significantly affected by adverse tax, legislative or political changes and the financial condition of the issues of municipal securities. Interest rate increases can cause the price of a bond to decrease. Income on municipal bonds is free from federal taxes but may be subject to the federal alternative minimum tax (AMT), state and local taxes. There are special risks associated with investments in **real assets** such as commodities and real estate securities. For commodities, risks may include market price fluctuations, regulatory changes, interest rate changes, credit risk, economic changes and the impact of adverse political or financial factors. Investments in real estate securities can be subject to fluctuations in the value of the underlying properties, the effect of economic conditions on real estate values, changes in interest rates and risks related to renting properties (such as rental defaults).

 ©2023 U.S. Bank.