We started off the year with some profit taking in tech stocks. No one wanted to pay capital gains tax in 2023, so those who wanted to reduce tech exposure delayed sales until 2024. We saw that in our own team’s model portfolio trades that we waited until the start of the year to apply for the same tax reason.

We had a flurry of data last week. And the data reinforces the recent narrative which is good news for the markets. The economy is moving forward at a healthy pace, I would even call it a “Goldilocks” pace. The data is not too strong to encourage the Federal Reserve (Fed) to tighten and certainly not too weak to start a slowdown in corporate profits.

Jobless claims came in strong, hovering around 200,000. Friday’s labor market report came in above consensus, but there were revisions to prior months that brought the total payroll growth over the last quarter lower. The unemployment rate came in 0.1% under expectation, matching the previous month. But hours worked dropped 1/10th of an hour—and that is enough to offset more than all of the jobs created—meaning total hours worked (hours worked time payroll) actually declined. So, the report was not quite as strong as some media reported.

What disturbed the market—and what I think caused the initial selloff in bonds—was the average hourly earnings coming in 0.1% above expectations and 0.2% above on a year-over-year basis. I’ve emphasized that many incorrectly see rising wages as inflationary. But the gap between wages and inflation is productivity growth and productivity growth has been extremely robust.

Average productivity growth in 2023 was around 2.5%. Wages were up to 4.1% year over year. Subtract those figures and you have an inflationary impulse of just 1.6%—below the Fed’s 2% target. Wages are an imperfect guide to inflationary pressures in the economy and that might increase if artificial intelligence (AI) technologies start to bear fruit.

What are the inflationary pressures in the economy? The Middle East conflict and the danger to cargo ships in the Red Sea have pushed oil up and could lead to other supply chain delays if shipping is being more permanently rerouted. But so far these tensions are only impacting oil and we see no signs in other commodities which have been stable if not declining.

There’s really not much else on the inflation front that is worrying but we’ll get more data this week with the Consumer Price Index (CPI) and Producer Price Index (PPI) reports.

I will reiterate my take from year end. Everyone is focused on how many rate cuts are priced into the Fed funds futures market and how we need six cuts to have a good 2024. I totally disagree with that.

The key point from the December Federal Open Market Committee (FOMC) meeting was Powell being more flexible and willing to cut rates if we have weakness. If real economic growth stays strong, the Fed could keep rates exactly where they are, and we could have strong equity markets.

What was important: Powell recognized the two-sided risks and is not necessarily going to stick to a false narrative that we have 1970’s style inflation. Powell’s flexibility means we should avoid the worst case of an overly stubborn Fed, and this lowers the probability of a recession and raises chances of continued growth or a softer landing.

If there is a flare up of inflation, that could become more negative. But I think the prospect of that is low.

My outlook for the S&P 500 for 2024 is another good year—in the order of 8-10% price gain—and I think value stocks, particularly smaller-cap value stocks, trading at much lower multiples could do better, with around 15% appreciation.

My long-term outlook on the bond market (beyond 2024) would be for the Fed funds rate to settle around 3% - 3.5% and to have 50-75 basis points in positive term premium (unlike the strong over 130 basis point curve inversion we have today). This would get a 10-year yield closer to 4%. That happens to be where the 10-year Treasury is trading today, so the upside on adding to bond duration here seems small given the yield sacrifice that has to be made.
Glossary

**Artificial Intelligence (AI):** A field which combines computer science and robust datasets to enable problem-solving.

**Basis point:** 1/100th of 1 percent.

**Commodity:** A raw material or primary agricultural product that can be bought and sold.

**Consumer Price Index (CPI):** A measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. The CPI is calculated by taking price changes for each item in the predetermined basket of goods and averaging them; the goods are weighted according to their importance. Changes in CPI are used to assess price changes associated with the cost of living. Core CPI excludes food and energy costs.

**Duration:** A measure of a bond’s sensitivity to changes in interest rates.

**Fed funds futures:** Financial contracts that represent the market opinion of where the daily official federal funds rate will be at the time of the contract expiry. The futures contracts are traded on the Chicago Mercantile Exchange (CME) and are cash settled on the last business day of every month. Fed fund futures can be traded every month as far out as 36 months.

**Fed funds rate:** The rate that banks that are members of the Federal Reserve system charge on overnight loans to one another. The Federal Open Market Committee sets this rate. Also referred to as the “policy rate” of the U.S. Federal Reserve.

**Federal Open Market Committee (FOMC):** The branch of the Federal Reserve Board that determines the direction of monetary policy.

**Federal Reserve (Fed):** The Federal Reserve System is the central banking system of the United States.

**Producer Price Index (PPI):** A weighted index of prices measured at the wholesale, or producer level.

**S&P 500 Index:** A market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor’s Index Committee designed to represent the performance of the leading industries in the United States economy.

**Treasury (UST):** Debt obligation issued by the U.S. government with payments of principal and interest backed by the full faith and credit of the U.S. government.

**Yield curve inversion:** An interest rate environment in which long-term debt instruments have a lower yield than short-term debt instruments of the same credit quality.

**Yield:** The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value.