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*advice; judgment; resolution; wisdom

# Resilient, But for Just How Much Longer?

We entered 2023 observing that the markets had spent the prior year adjusting to the Federal Reserve's relentless tightening cycle, which was likely to produce a recession. But stocks had already gone a long way toward reflecting that outcome; therefore, we thought it plausible that markets might also look well into the future for signs of a reversal in Fed policy, and rally in anticipation of a better outlook for 2024. We also expected inflation to decline markedly as the year progressed, making an eventual Fed "pivot" even more likely. "There is a very good chance markets will be higher a year from now notwithstanding the possibility of economic pain in the interim," we noted in early January.

It appears we may end up having been right, but for the wrong reasons. The S&P 500 Index, even following declines in August and September, is up a solid 13.1% this year, and the year-on-year pace of inflation has been cut nearly in half.

But a Fed pivot is nowhere in sight, because the economy has performed better than nearly anyone had expected, keeping inflation stubbornly above its 2% long-term target rate. This year, employment growth has remained solid, leading to good growth in personal income and spending, and real GDP has expanded moderately.

We erred in our recession assessment for a simple reason: we underestimated the lag time between the start of the Fed's tightening cycle and its full economic impact. Consumers, for example, were unresponsive to the tightening because they had built up substantial excess savings during Covid, and had significant pent-up demand, especially for services. They also went on a credit card binge, increasing their borrowings by over 30% in the last two years. Homeowners were unresponsive because they had locked in very low mortgage rates that will hold monthly payments down for years to come. Corporations were unresponsive for much the same reason, having termed out their debt maturities at very low rates. And for much of the year, the stock market itself was almost shockingly unresponsive, as a small handful of large technology stocks were lifted by the mania for all things "AI" and carried the indexes upward, masking the fact that the average S&P stock was making little progress (and is now down on the year).

But the fumes that powered this behavior have nearly completely dissipated. Excess savings, particularly for lower- and middle-income consumers, have been spent down, and delinquencies on credit cards and car loans, as well as bankruptcies, are on the rise. Employment growth is still positive, but it has slowed sharply from last year's torrid pace, and slower wage growth will follow. Finally, cooler heads are beginning to reassess the potential for AI to contribute meaningfully to earnings growth over a normal investment horizon.

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Of late, a strong narrative around a "soft landing" for the economy has emerged, calling for moderate growth, allowing inflation to continue to fall, enabling the Fed to end its tightening cycle, and indeed setting the stage for rate cuts down the road. This set of events has occurred only once in Federal Reserve history, and it is a needle-threading, "Goldilocks" scenario that should be treated with caution. For such an outcome, the Fed must hold short-term interest rates "higher for longer", something that is now being more fully reflected by the rise in long-term interest rates. Further, a soft landing implies a subsequent takeoff/reacceleration – and unless a good amount of economic slack has been accumulated in the interim, inflation pressures will likely resume. Thus, a soft landing merely implies a deferral of additional Fed tightening.

We have noted numerous times in recent years that we are living through an unprecedented cycle, and that being open to unexpected outcomes is mandatory. But there is no doubt that conditions are markedly different now than they were at the beginning of the year: the Fed is not about to change course; and, having risen meaningfully from its lows last fall, the market is no longer reflecting bad news – if anything it has, until very recently, been reflecting a high level of confidence in a historically unlikely scenario.

Make no mistake, interest rates – both the level and the direction – are a problem that an expensive stock market ignored for much of the year. The last time 10-year US Treasury yields were in the vicinity of 4.5%, in 2007, the S&P 500 Index traded at valuations roughly 25% lower than today's levels. A powerful earnings story can overcome rising rates, but earnings growth is weak at the moment for most companies. And, corporate boards may be showing signs of worry over their own business outlooks – S&P 500 dividends declined year-on-year in the third quarter, a very rare event outside of recessions.

We've never had a confluence of events such as what we are currently experiencing and not had a subsequent downturn and a reset for stock prices. A recession delayed is not a recession cancelled. But since 1950, the S&P 500 has generated a positive total return in the fourth quarter an amazing 86% of the time. This fact alone supports a call for patience and avoiding any precipitous portfolio action in the near term. Could the best-case scenario turn out to be correct? We will keep an open mind and maintain our focus on owning high quality companies with durable long-term prospects that we expect to perform well across inevitable market cycles.

*Sources: FactSet, JPMorgan, Federal Reserve Bank of St. Louis*

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