

# A Slower Pace to Lower Rates

## January 2024 Market Commentary

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## Economic Update: Above-Trend Growth Helped by Higher Productivity and Disinflation



### Cut in Interest Rates Delayed But Still in Play:

- Fixed income markets push first rate cut to May FOMC from March FOMC following Fed Chair Powell press conference remarks.
- U.S. real economic growth continues to trend higher, helped by productivity and disinflation.
- Optimistic consensus outlook for U.S. earnings growth of annualized 11-12% over next two years, driven by large cap technology.



### Near-Term Risks that Could Upend Soft Landing:

- Near-term supply-induced shock from global shipping rates due to Mideast conflict.
- Services inflation remains sticky preventing central banks from achieving long-term inflation targets.
- Housing appreciation starts to pick up with lower rates.
- Positive fiscal spending impulse in an election year means more deficit spending and bond issuance.



### 2024 GDP Bloomberg Consensus:

- US: +1.5%
- Europe: +0.5%
- Japan: +0.8%
- China: +4.6%

## What Happened and What To Do About It

- We maintain a neutral/cautious outlook on equities and risky fixed income due to higher valuations (lower risk premiums) that afford smaller margins of error in the event a soft landing does not occur.
- Investors should increase diversification by allocating to fixed income and equity alternatives such as real estate and commodities to reduce overall portfolio volatility in the face of a multitude of economic and monetary scenarios.
- Investors looking to put new money into the markets should consider a dollar cost averaging program and tilt towards areas of the market offering more balanced risk-reward.
- U.S. market valuations continue to widen versus the rest of the world as does valuations between U.S. large caps and small caps, mainly driven by the outperformance of the Magnificent 7 and technology growth stocks benefiting from artificial intelligence and cloud infrastructure spending.
- For CY 2024, Wall Street analysts expect S&P 500 earnings to grow 11.6% on revenue growth of 5.4%, with much of that growth backend loaded to Q4202.
- This remains a show-me market where the earnings 'haves' continue to outpace the 'have-nots' which may prove to be a headwind for globally diversified portfolios.
- If the Fed pursues the easing campaign anticipated by the markets (5-6 rate cuts in 2024), then rate-sensitive segments such as small caps, cyclicals, financials, and real estate as well as those with marginal balance sheets would likely benefit. A weaker U.S. dollar makes foreign markets and hard assets (i.e. commodities) more attractive.
- Despite the year-end rally in fixed income as global interest rates dropped from late Autumn peak levels, real (inflation-adjusted) bond yields remain positive and attractive. Should the Fed pursue its rate cut campaign, then the current high rates offered by short-term vehicles such as money markets could be cut nearly in half within the next two years.
- Corporate credit risk as expressed by yield spreads above comparable government rates has declined in anticipation of a benign financing environment of lower rates but a smaller chance of an outright recession that would stress corporate balance sheets. Should the Fed pursue its rate cut campaign, then more of the yield offered by risky fixed income would compose of credit risk as opposed to base interest rates. As such, we are more cautious on corporate credit risk while finding longer maturities more attractive than shorter maturities.
- Risk premiums as expressed by implied volatility from option pricing have also compressed to well below historical average levels, suggesting that investors selling volatility through covered call writing programs might consider other de-risking alternatives such as reducing overall equity allocations and/or raising cash.

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## Key Benchmarks: Performance and Characteristics as of 1/31/2024

Equities	MTD	QTD	YTD	1-Yr Fwd P/E: Current vs 10-Yr Range			
S&P 500	1.7%	1.7%	1.7%	20.1x	14.6x	22.9x	
MSCI EAFE	0.6%	0.6%	0.6%	13.8x	11.2x	18.2x	
MSCI Emerging	-4.6%	-4.6%	-4.6%	11.4x	9.7x	15.3x	
Fixed Income	MTD	QTD	YTD	Real Assets	MTD	QTD	YTD
Bloomberg U.S. Aggregate	-0.3%	-0.3%	-0.3%	US REITs	-4.9%	-4.9%	-4.9%
Bloomberg U.S. High Yield	0.0%	0.0%	0.0%	GSCI Commodities	4.5%	4.5%	4.5%
Bloomberg Global Agg ex U.S.	-2.3%	-2.3%	-2.3%	GSCI Prec Metals	-0.9%	-0.9%	-0.9%

Data Source: Bloomberg

## A Slower Pace to Lower Rates



Source: istockphoto.com

*"[The Federal Reserve Board Voting Members] believe that our policy rate is likely at its peak for this tightening cycle and that, if the economy evolves broadly as expected, it will likely be appropriate to begin dialing back policy restraint at some point this year. But the economy has surprised forecasters in many ways since the pandemic, and ongoing progress toward our 2 percent inflation objective is not assured."*

*– Fed Chair Jerome Powell Opening Statement Following 1/31/2024 FOMC<sup>1</sup>*

Global risk assets started the year on strong footing following the prior quarter-end rally that saw the S&P 500 return over 26% in 2023. Bond markets were also sanguine with the 10-year Treasury yield near its 6-month bottom of 3.8% and Fed Funds Futures pricing a near certainty that the Federal Reserve would begin cutting rates at the March FOMC.

But then Fed governor and board member Christopher Waller threw some cold water on early rate cut prospects. In a Brookings Institute moderated panel, Waller remarked that the U.S. economy was doing quite well, and although inflation continued to moderate, the Fed did not want to run the risk of undoing the progress made with monetary tightening (rate hikes, quantitative tightening of the balance sheet). He remarked, "The worst thing we'd have is it all reverses after we've already started to cut. We really want to see evidence that this progress...in the real data and the inflation data continues."<sup>2</sup>

As the month progressed, the bond market began to level set to a new reality that the U.S. economy was reaccelerating (witness strong retail sales, rebounding industrial activity and spending). Combined with renewed concerns over supply chain issues stemming from the rerouting of global shipping away from the Middle East (due to Houthi targeting of container ships), progress on the inflation front could be undermined with too early monetary policy easing.

The January FOMC and post-meeting press conference remarks made by Chair Jerome Powell, threw more cold water on a rate cut in March<sup>3</sup>, although Fed Funds Futures merely increased pushed the first rate cut to May FOMC from March (**Figure 1**). It would seem the Fed requires more tangible evidence of softening demand (particularly labor demand) and sustainable progress on disinflation for the Fed to feel more confident in cutting rates without some financial or economic calamity to force them into panic rate-cutting mode.

<sup>1</sup> ["Transcript of Chair Powell's Press Conference January 31, 2024"](#), Federal Reserve

<sup>2</sup> ["Fed's Waller says US 'within striking distance' of inflation goal,"](#) Reuters, 1/16/2024

<sup>3</sup> ["Fed Meeting January 2024: Markets React as Powell Pushes Back on March Rate Cut,"](#) Bloomberg, 1/31/2024

Figure 1 – First Expected Rate Cut Pushed to May from March Following January FOMC

Region: United States »		Instrument: Fed Funds Futures »	
Target Rate	5.50	Pricing Date	01/31/2024
Effective Rate	5.33	Cur. Imp. O/N Rate	5.319

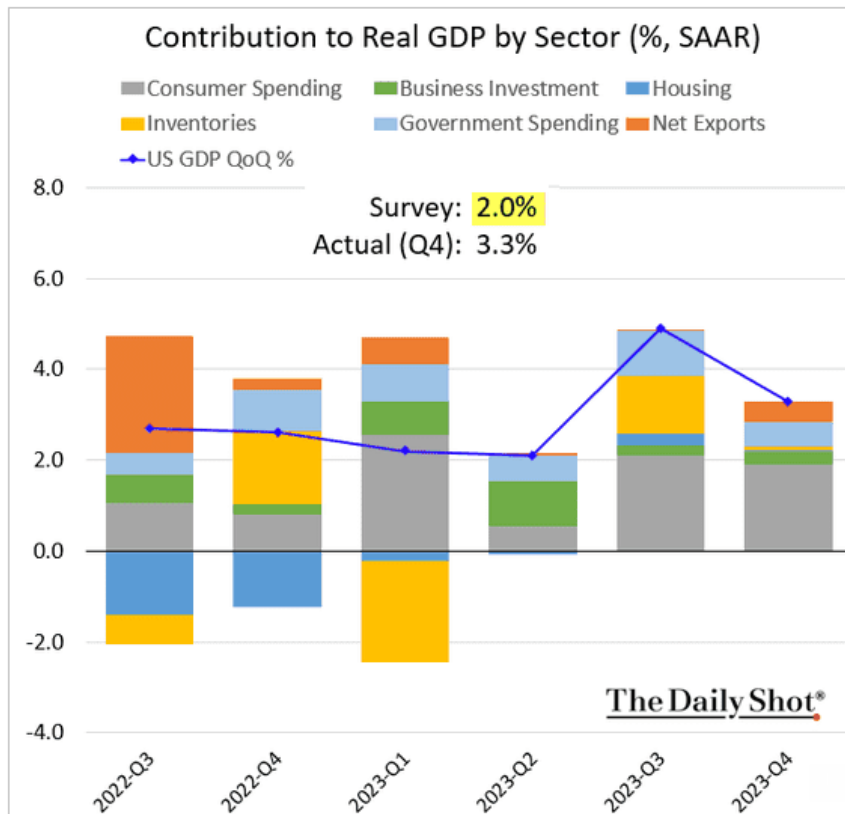
  

Meeting	#Hikes/Cuts	%Hike/Cut	Imp. Rate Δ	Implied Rate	A.R.M.
03/20/2024	-0.349	-34.9%	-0.087	5.232	0.250
05/01/2024	-1.316	-96.8%	-0.329	4.990	0.250
06/12/2024	-2.438	-112.2%	-0.609	4.709	0.250
07/31/2024	-3.395	-95.7%	-0.849	4.470	0.250
09/18/2024	-4.390	-99.5%	-1.098	4.221	0.250
11/07/2024	-5.089	-69.9%	-1.272	4.046	0.250
12/18/2024	-5.825	-73.5%	-1.456	3.863	0.250
01/29/2025	-6.515	-69.0%	-1.629	3.690	0.250

Source: Bloomberg World Interest Rate Probability (WIRP)

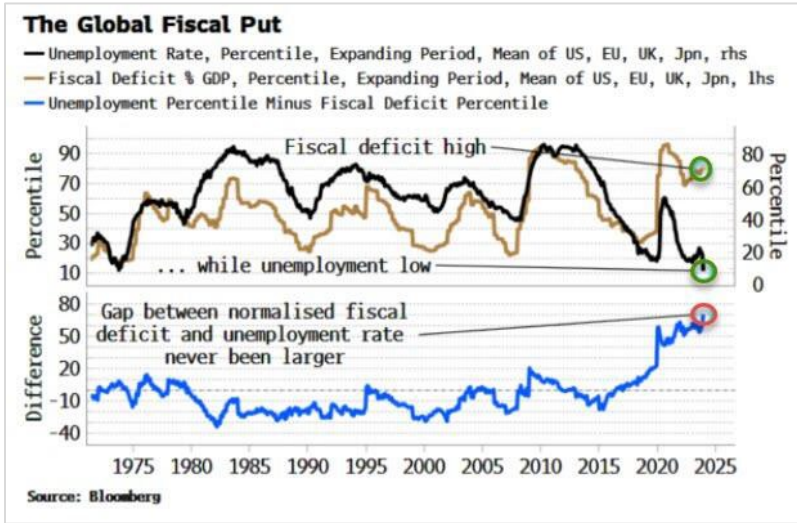
Although the rest of the world is showing signs of economic slowing, the U.S. economy continues to trend higher even with higher interest rates and sticky inflation. The advanced reading of 4Q2023 real GDP growth surprised economists coming in at 3.3% annualized versus 2.0% expected (Figure 2).

Figure 2 – 4Q2023 Real GDP Growth Helped by Personal Spending and Investments



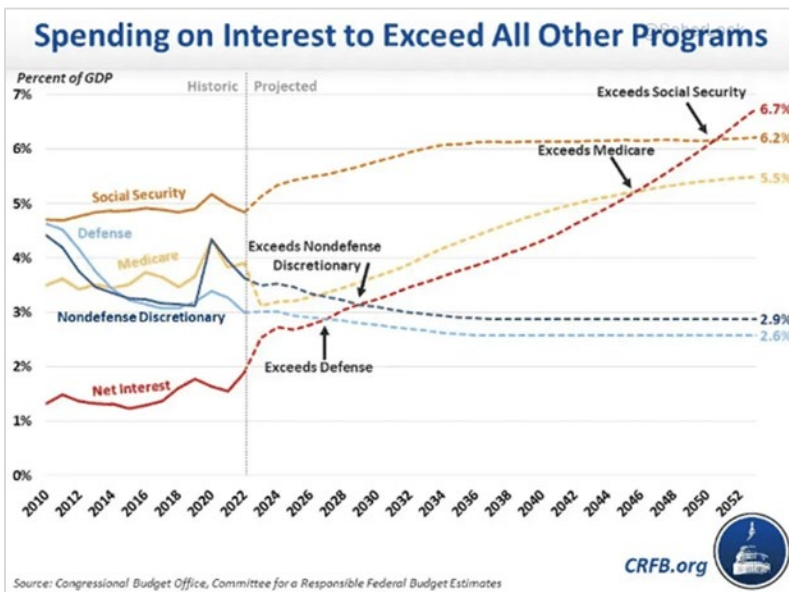
Government deficit spending has also been a major contributor and will likely remain a tailwind as fiscal spending makes its way down to the state and local level. Government spending continues to support labor markets at levels not seen in prior cycles (Figure 3).

**Figure 3 – Fiscal Tailwind for Labor Markets at Levels Not Seen in Prior Cycles**



The risk is that the U.S. is running 6-7% deficit/GDP spending levels at the top of the cycle which would leave the government little room to enact countercyclical measures should the economy slow down or contract. One of the risks we highlighted in our 2024 Market Outlook is that the cost of public debt financing is not sustainable over the long run as the Congressional Budget Office is now projecting interest expense as a % of GDP to overtake defense spending over the near term and then major entitlements over the next two decades at the current rate of deficit financing (Figure 4).

**Figure 4 – Interest on Public Debt Expected to Exceed Defense and Entitlement Spending**



Another risk on the inflation front is a reversion in core goods pricing as supply chain issues resurface (Figure 5), this time with global maritime shipping (Figure 6). However, this could prove to be transitory if a ceasefire is agreed to in the Middle East and a cessation of rocket attacks from Houthi rebels.

Figure 5 – Supply Chain Constraints Could Introduce a New Wave of Core Goods Inflation

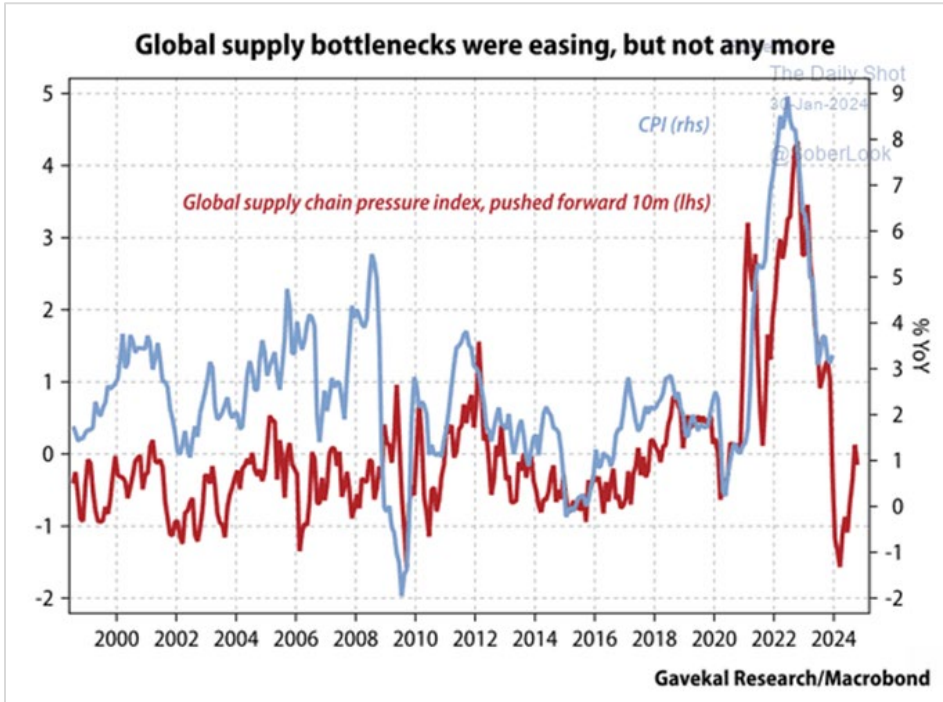
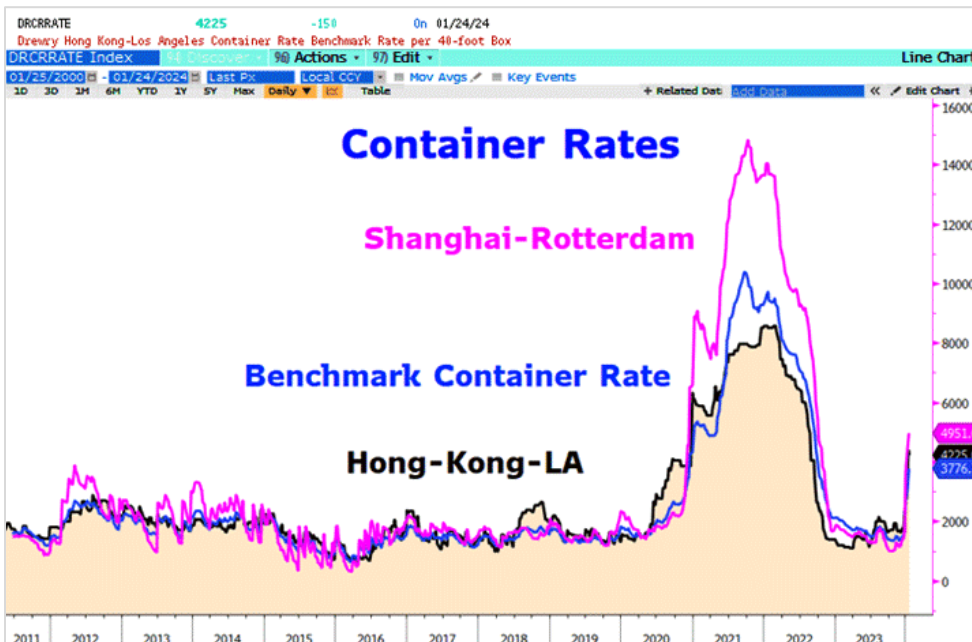


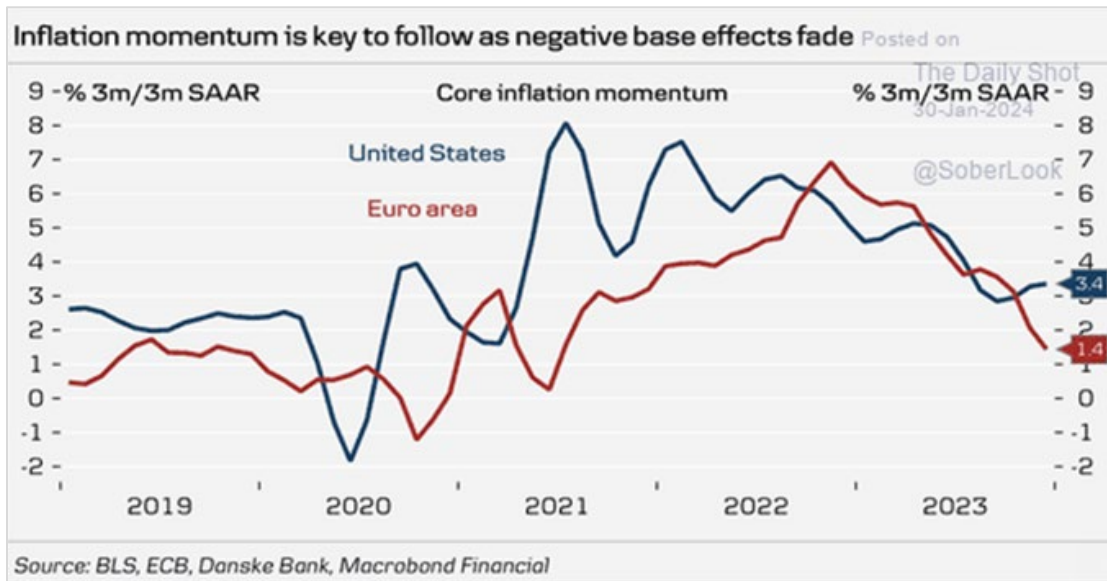
Figure 6 – Global Container Rates Soar Over Middle East Conflict



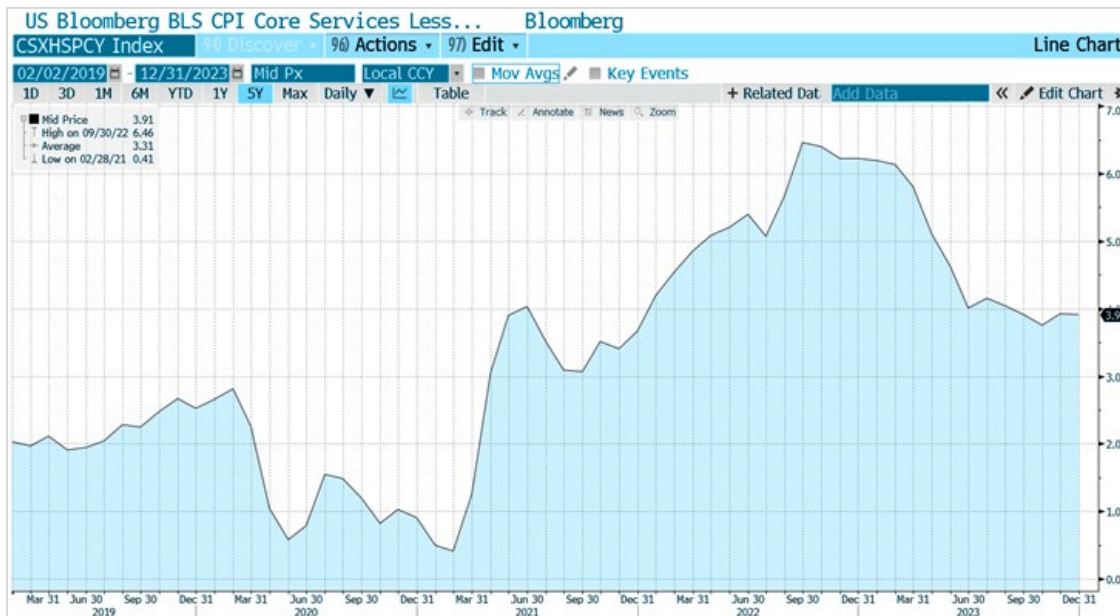
Source: Bloomberg and Bear Traps Report

Admittedly, the supply chain issues are more likely to pressure European inflation through energy imports versus the U.S. which is still exporting energy. However, as alluded to earlier, progress is being made on inflation across both regions (**Figure 7**), but achieving desired inflation rates remains difficult to reach due to core services (**Figure 8**) as labor markets remain “tight by historical standards,<sup>4</sup>”

**Figure 7 – Getting that Last Leg Down in Inflation Is Proving to Be a Challenge**



**Figure 8 – Core Services ex Housing Inflation (Supercore) Remains Elevated**

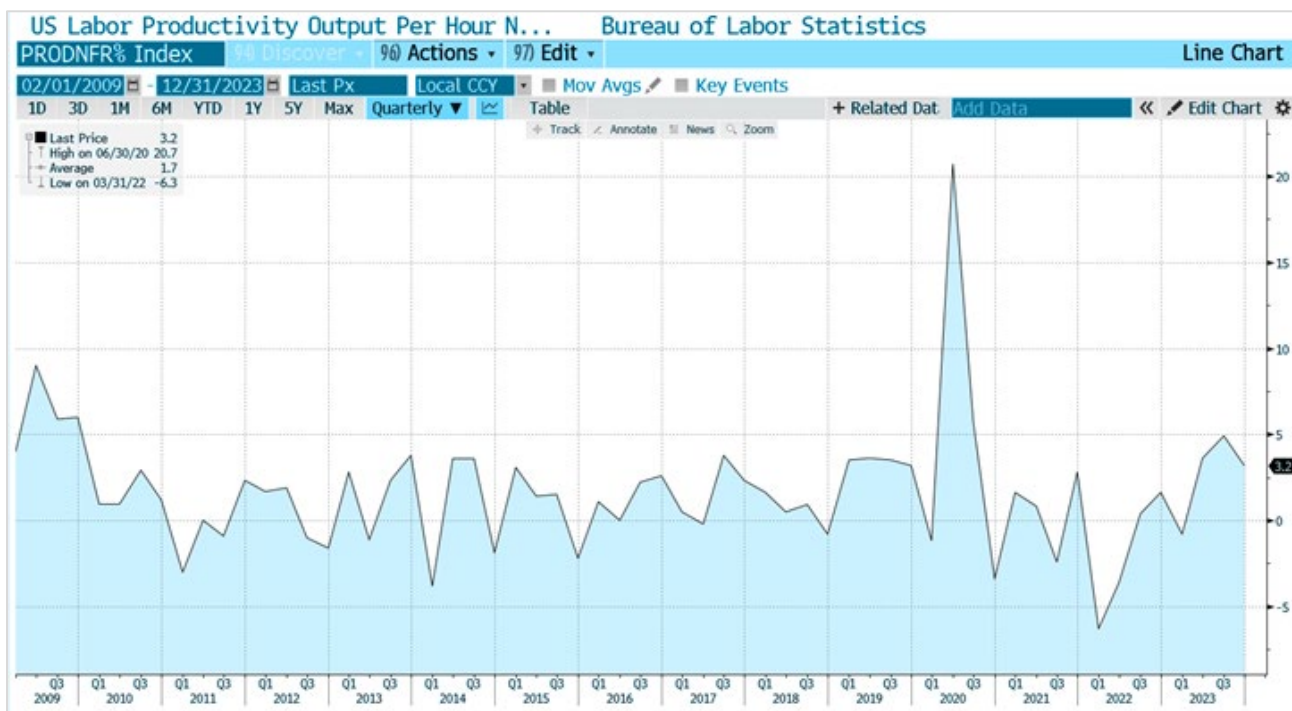


Source: Bloomberg

<sup>4</sup> “Monetary Policy Summary, February 2024,” Bank of England

Despite these headwinds, U.S. productivity continues to trend positively (**Figure 9**), which should help businesses maintain profitability and production while absorbing higher labor costs. Should post-pandemic productivity gains prove to be more than transitory, then the Federal Reserve has a wider runway to consider preemptive rate cuts well before a meaningful slowdown in labor market conditions.

**Figure 9 – Post-Pandemic U.S. Productivity Gains Proving to Be More Than Transitory**



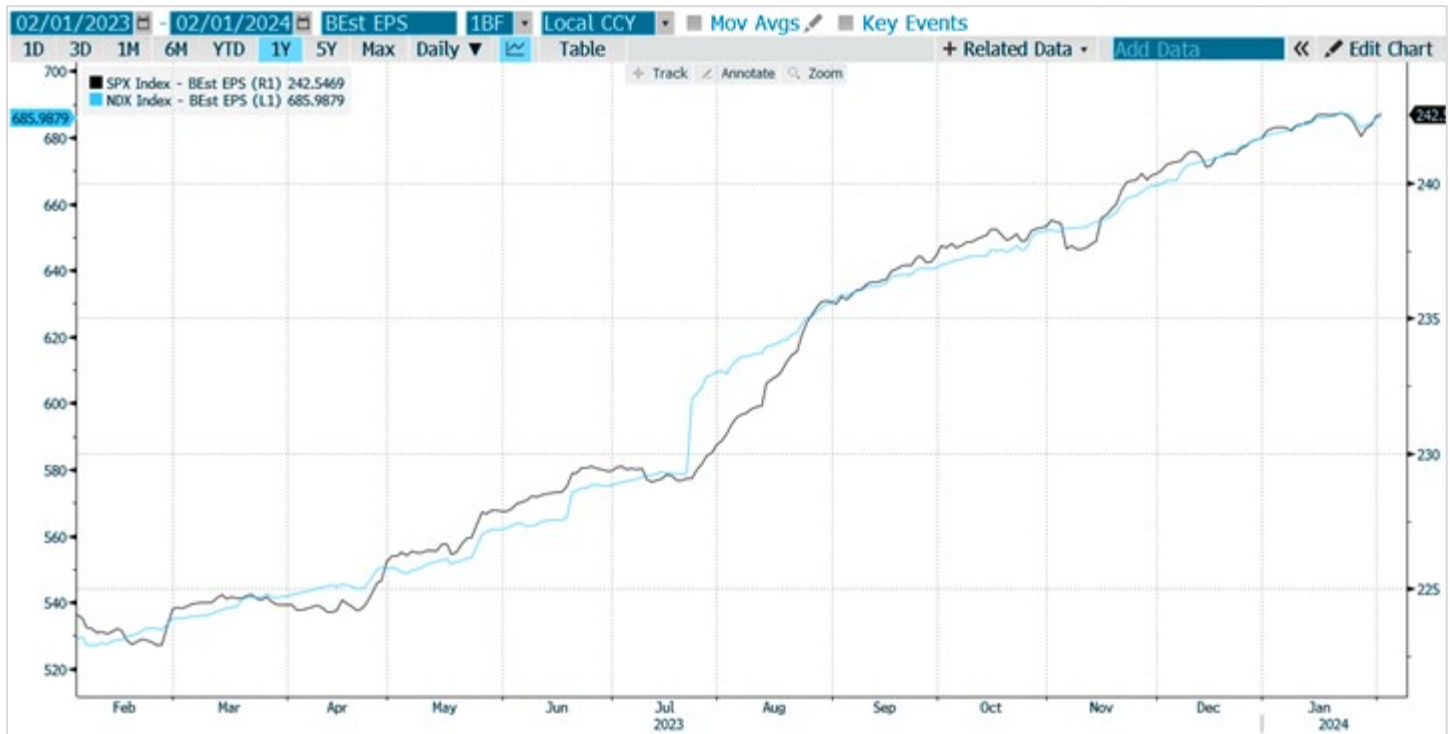
Source: Bloomberg

Finally, U.S. market valuations continue to widen versus the rest of the world as do valuations between U.S. large caps versus small caps, mainly driven by the outperformance of the Magnificent 7 and technology growth stocks benefiting from artificial intelligence and cloud infrastructure spending. According to the 1/26/2024 edition of Factset Earnings Insight, “six of the seven [Magnificent 7 companies] are projected to be the top six positive contributors to year-over-year earnings for the S&P 500 for Q42023...<sup>5</sup>” For CY 2024, Wall Street analysts expect S&P 500 earnings to grow 11.6% on revenue growth of 5.4%, with much of that growth backend loaded to Q42024.

<sup>5</sup> Factset Earnings Insight, 1/26/2024

The expected earnings growth for the Nasdaq 100 continues to pull up the aggregate earnings outlook for the rest of the S&P 500 (**Figure 10**), suggesting that investors are willing to pay up for earnings growth stories at the expense of the rest of the market not able to keep pace with the technology growth narrative. This remains a show-me market where the earnings 'haves' continue to outpace the 'have-nots' which may prove to be a headwind for globally diversified portfolios.

**Figure 10 – Nasdaq 100 Earnings Outlook Continues to Anchor Overall S&P 500 Outlook**



Source: Bloomberg

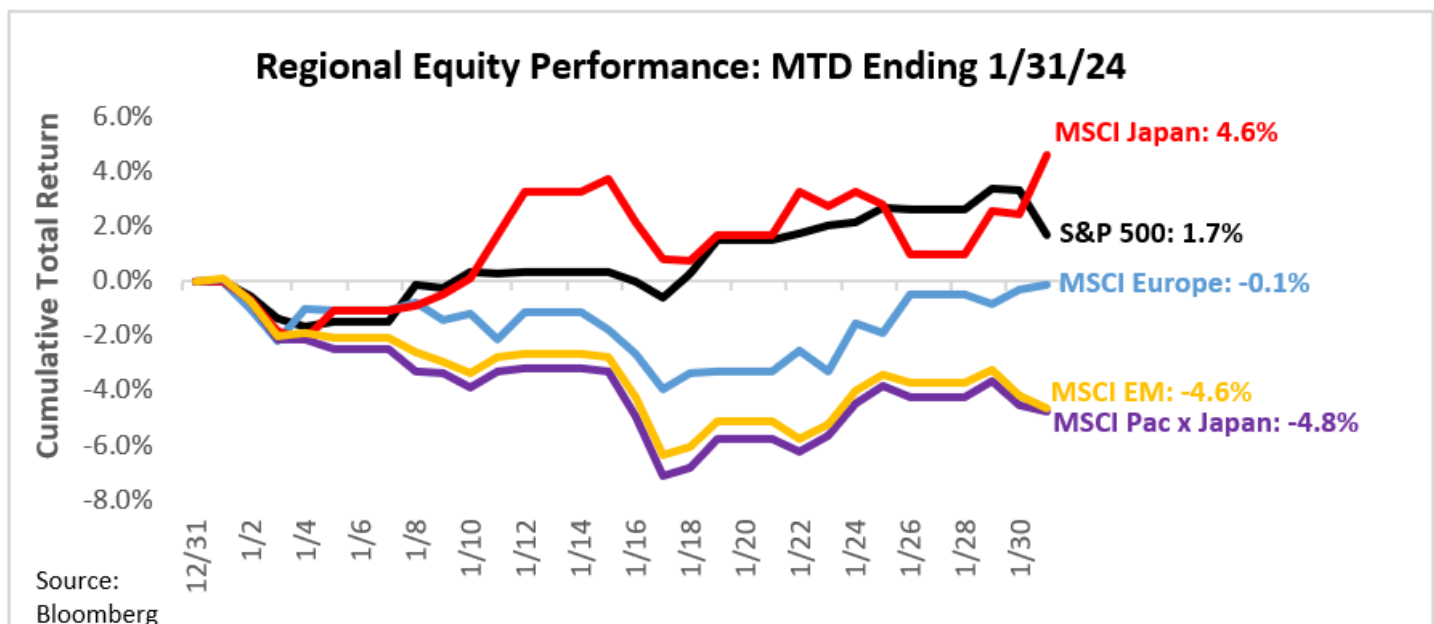
### January 2024 Market Review

Global equity markets started the year on a more positive note but then pulled back over 1) 4Q U.S. earnings disappointments/outlooks from cyclical and financial bellwethers, 2) geopolitical tensions driving global freight costs and delays, and 3) pushback from Federal Reserve officials over aggressive rate cut schedule implied by market pricing. As had been the case throughout 2023, U.S. equities experienced narrower breadth with only a handful of technology growth semiconductor companies (beneficiaries of generative artificial intelligence spending) and consumer discretionary stocks contributing to positive U.S. equity performance.

Emerging market investors were also disappointed over China’s lackluster economic outlook, despite doubling down on the mercantilist playbook of pushing industrial production and global exports, as the beleaguered property sector is still weighing on the country’s financial system, culminating in the Hong Kong court-ordered liquidation of Evergrande. It is unclear whether Chinese officials will move forward with the liquidation or seek to engineer their own restructuring, bypassing the Hong Kong legal system and introducing another degree of uncertainty (rule-of-law) for those investing in China<sup>6</sup>.

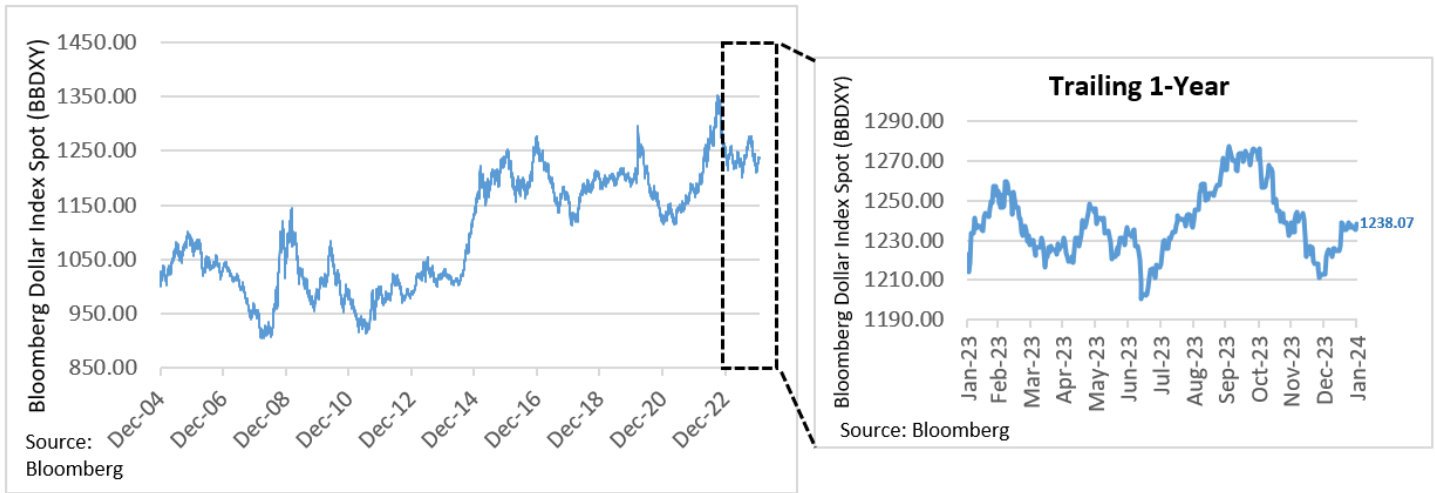
The MSCI All-Country World Index returned +0.6% for the month of January. Across major regions (Figure 11), Japan and U.S. markets outperformed Europe, Pan-Asian, and Emerging Markets. For the month, MSCI Japan returned +4.6%, helped by a strong Yen appreciation, and the S&P 500 returned +1.7%, outperforming MSCI Europe (-0.1%), MSCI Emerging Markets (-4.6%), and MSCI Pacific ex Japan (-4.8%). The U.S. dollar (Figure 12) strengthened in January, as expectations for an early U.S. rate cut cycle were scaled back.

**Figure 11 – Europe and the U.S. Outperformed Asia Developed and Emerging Markets**



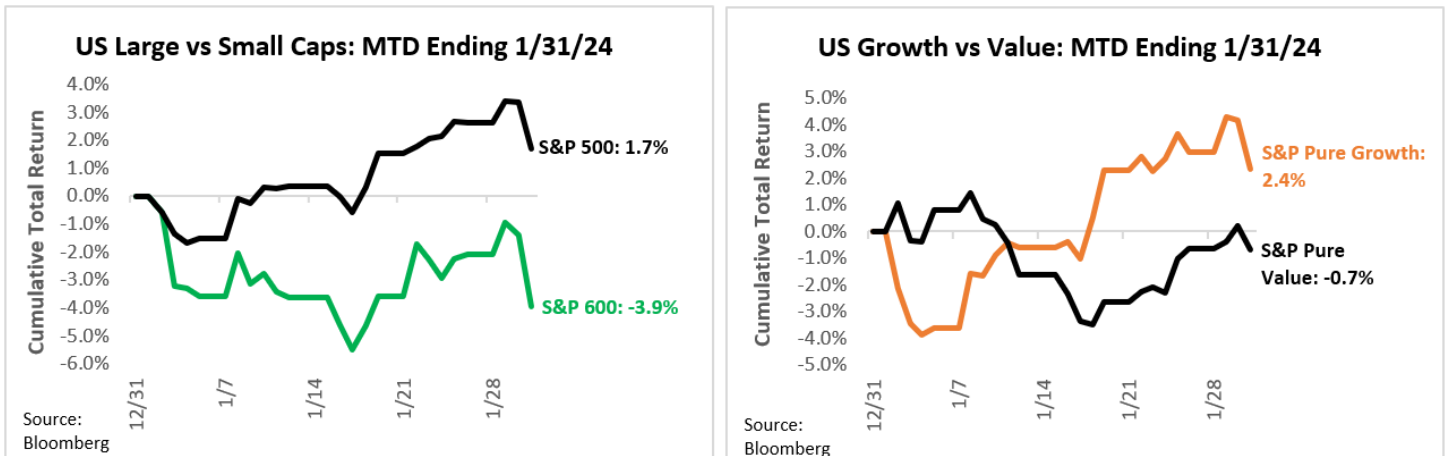
<sup>6</sup> “Is this the end of Evergrande? Here’s what may happen next.” CNN, 1/31/2024

**Figure 12 – The U.S. Dollar Appreciated as Early Expectations for Rate Cuts Were Scaled Back**



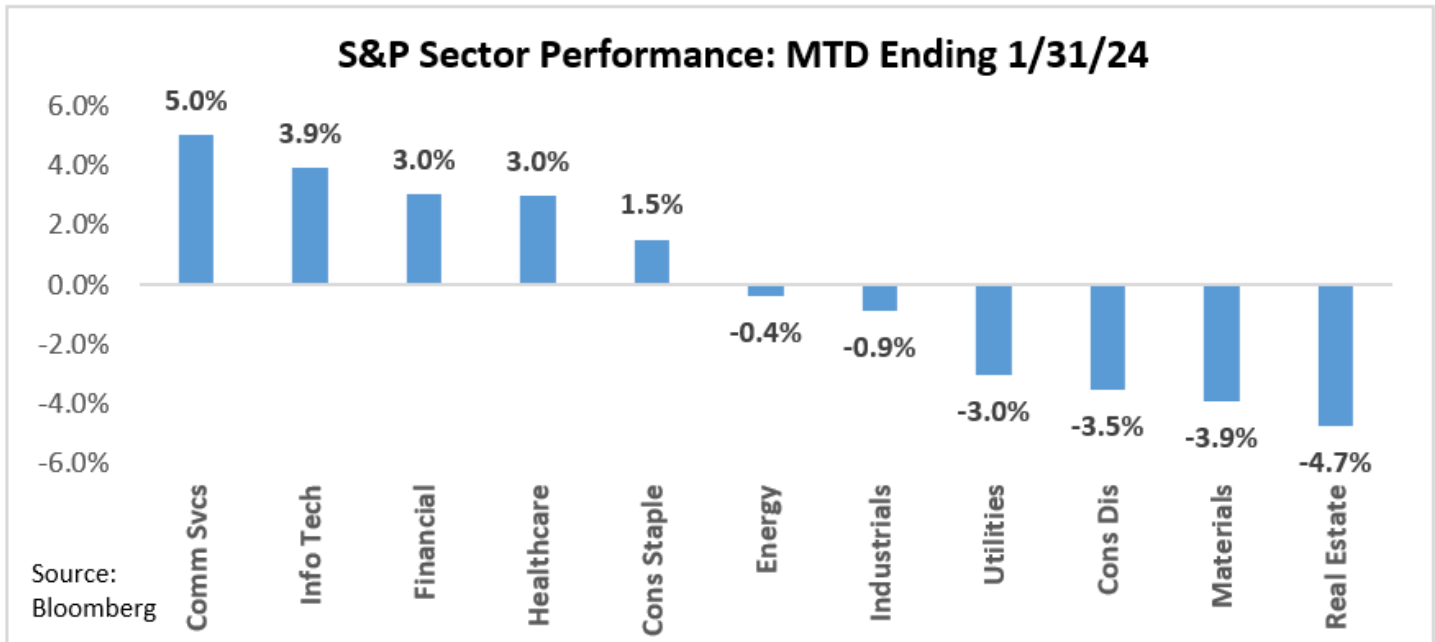
Within the U.S., small caps underperformed large caps and value stocks underperformed growth stocks, reversing some of its 4Q2023 outperformance as higher interest rates and diminished prospects for Fed rate cuts led investors to crowd back into large cap growth stocks. For the month of January (**Figure 13**), the S&P 500 Index returned +1.4% versus -3.9% for the S&P 600. S&P Pure Value underperformed Pure Growth, returning -0.7% and +2.4%, respectively.

**Figure 13 – Small Caps Underperformed Large Caps and Value Outperformed Growth**



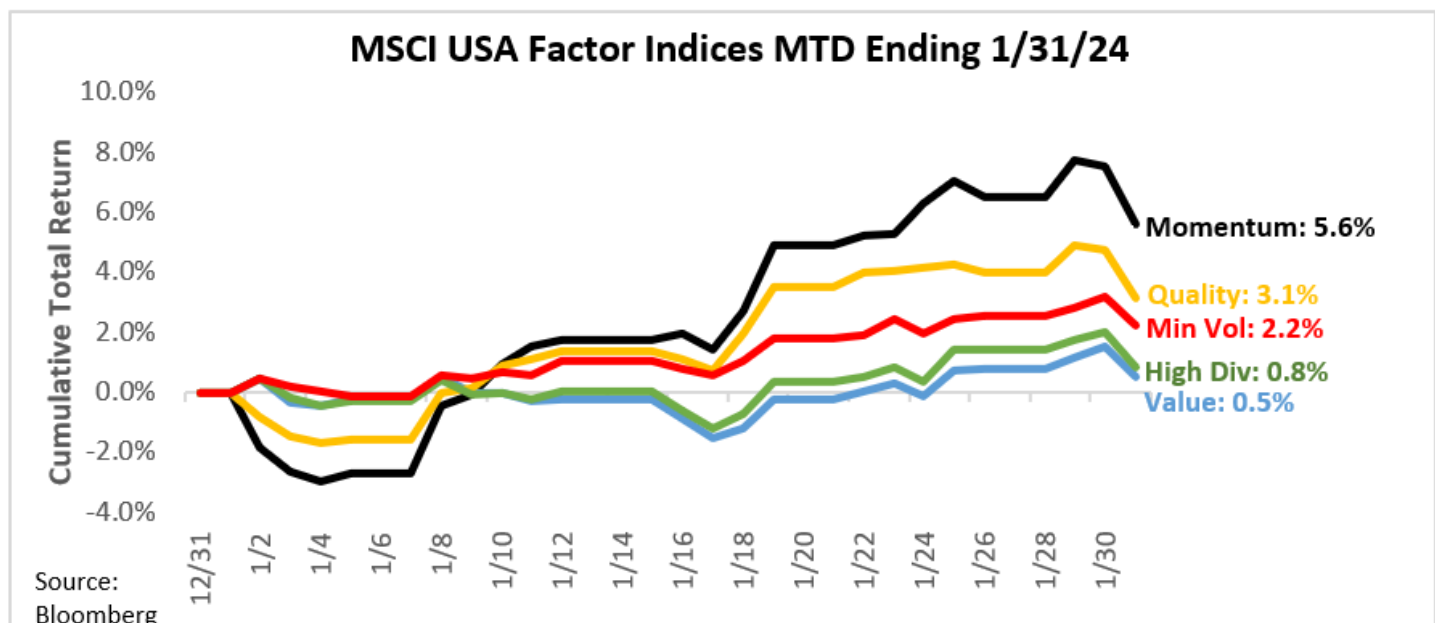
Across sectors (**Figure 14**), growth sectors (Communication Services, Technology, Consumer Discretionary), Financials, and Healthcare outperformed traditional cyclicals (Industrials, Energy, Materials) and interest-sensitive sectors (Utilities, Real Estate), with the latter hurt by a back up in interest rates and credit-related issues surfacing across real estate.

**Figure 14 – Growth Sectors Outperformed Traditional Cyclicals and Interest-Sensitive Sectors**



Among major risk factors (**Figure 15**), Momentum and High Quality outperformed Minimum Volatility, Value and High Dividend as high growth risk saw a persistent bid throughout the month.

**Figure 15 – Momentum and High Quality Factors Outperformed in January**



Fixed Income markets rallied from mid-month sell-offs as interest rates rose then dropped at the end of the month, while corporate credit spreads continue to narrow. The Bloomberg U.S. Aggregate Bond Index returned -0.3% for the month (**Figure 16**), as the 10-Year Treasury yield ended the month at 3.9%, down from an intramonth peak of 4.2%. Corporate bonds continue to outperform as borrowing spreads (**Figure 17**) narrowed further with companies able to take advantage of the issuance calendar to refinance debt. Global bond yields also rose from beginning of month levels (**Figure 18**).

The Global ex-U.S. Aggregate Index returned -2.3%, underperforming the U.S. Agg, reflecting U.S. dollar strength against non-U.S. currencies. Bloomberg Emerging Market Local Currency also underperformed U.S. fixed income, returning -1.3% for the month, while Bloomberg US High Yield continued its strong post-pandemic outperformance, returning 0.0% for the month, as high yield debt benefited from spread compression and lower maturity profile versus investment grade.

The 2-10 Year Term structure (**Figure 19**) steepened throughout January while inflation expectations (implied by breakeven rates between TIPS vs Nominal Treasury yields) rose end of year bottom levels, implying a rising risk of another inflation wave, whether due to a reaccelerating economy or new supply-chain price pressures stemming from higher global transportation costs.

**Figure 16 – Fixed Income Was Moderately Down in January as Interest Rates Rose from the Beginning of the Month**

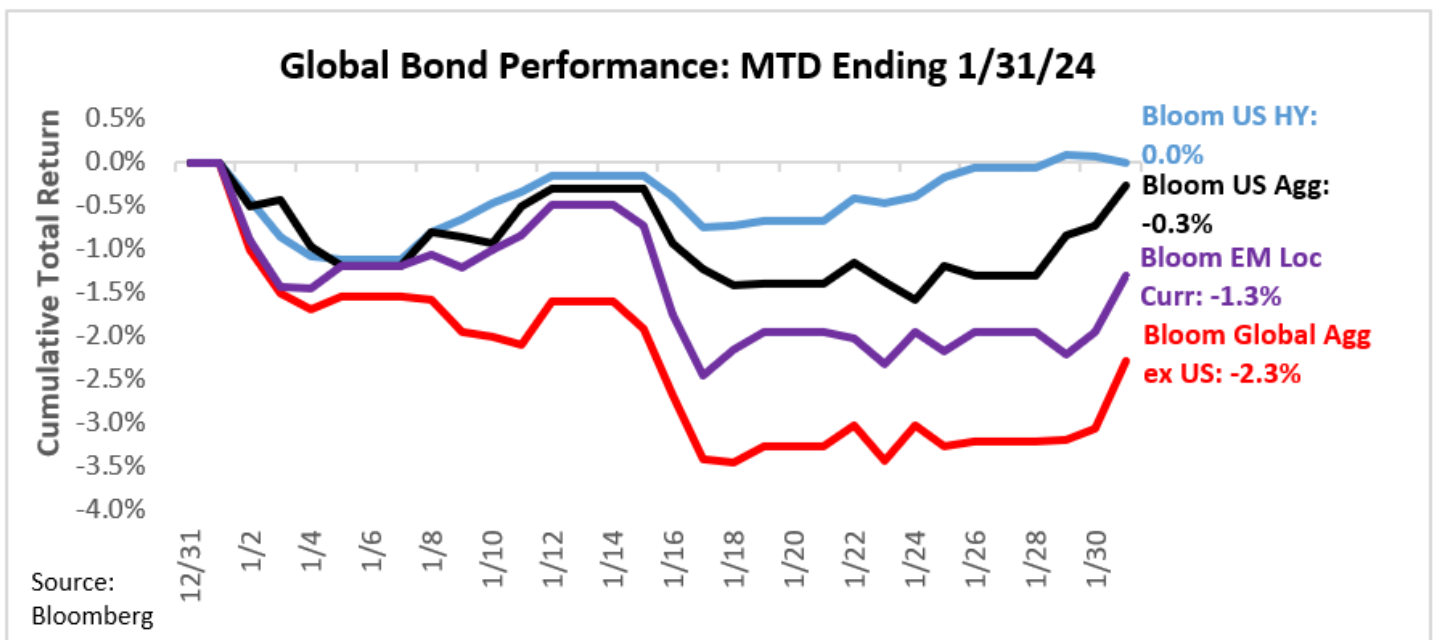


Figure 17 – Corporate Borrowing Spreads Narrowed Further in January

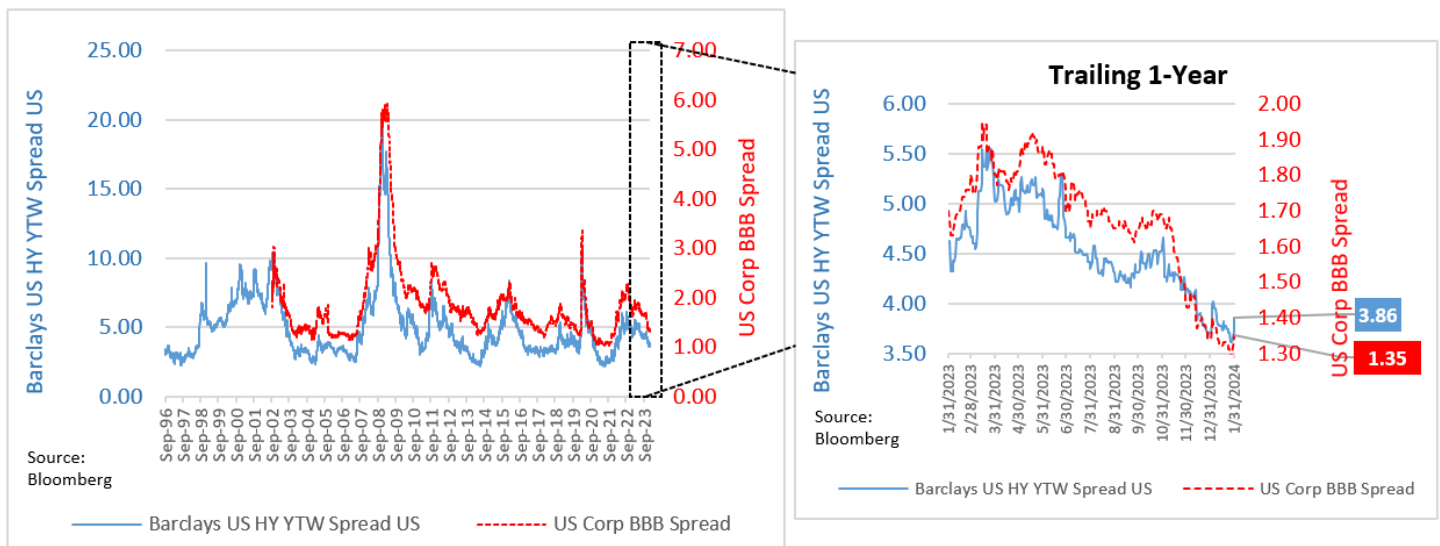
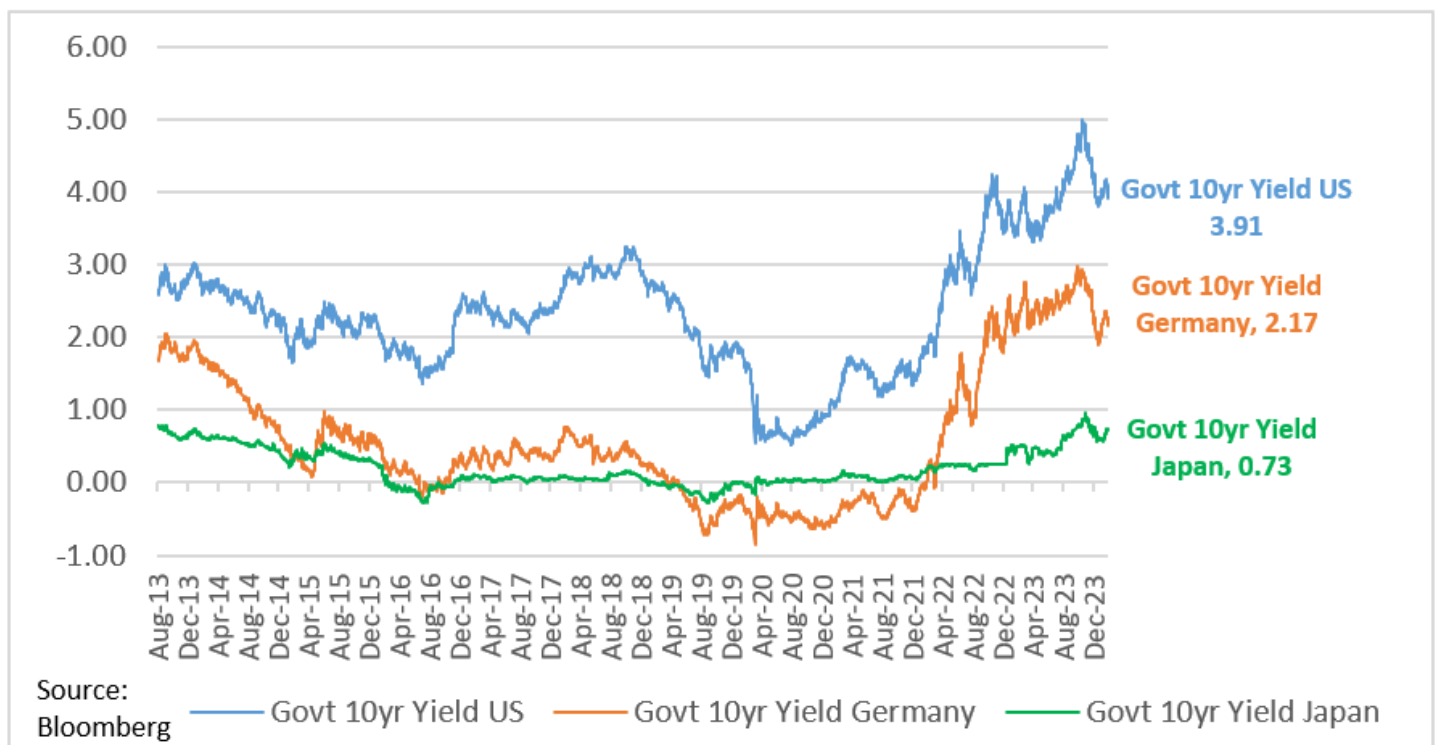
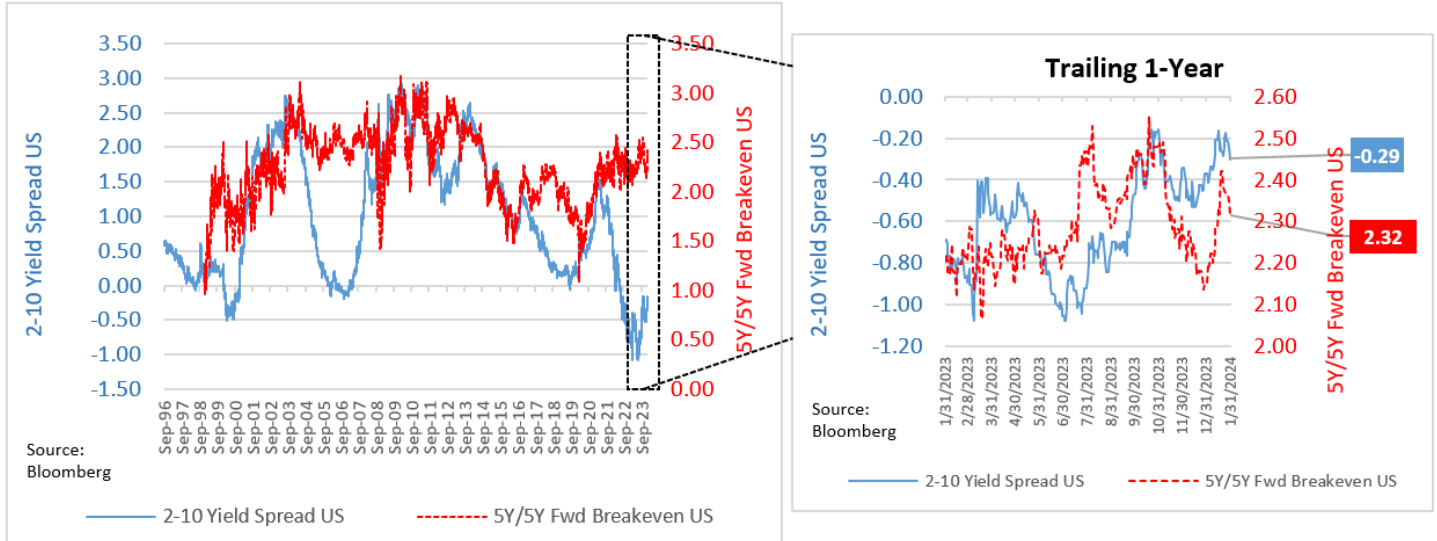


Figure 18 – Key Sovereign Bond Yields Rose Slightly from Beginning of Month Levels



**Figure 19 – 2-10 Year Term Structure Steepened While Inflation Breakeven Rates Rose Implying Higher Risk of Renewed Inflation**



Within equity alternatives (**Figure 20**), commodities outperformed, with most major categories experiencing positive returns (the one major exception being natural gas – **Figure 21**). Gold prices also but pulled back towards the end of the month when it became less clear the Fed would be cutting rates as early as March. Real estate continues to be plagued with fundamental issues surrounding distressed commercial properties (office, multifamily). In January, the S&P GSCI Commodities Index returned +4.5% while the S&P GSCI Precious Metals Index returned +0.9% and the Dow Jones REIT Index returning -4.9%.

**Figure 20 – In January, Real Estate Recovered Sharply Benefiting from Prospects of Easier Fed Policy in 2024 while Precious Metals Rallied as Spot Gold Rose Above \$2000/Oz**

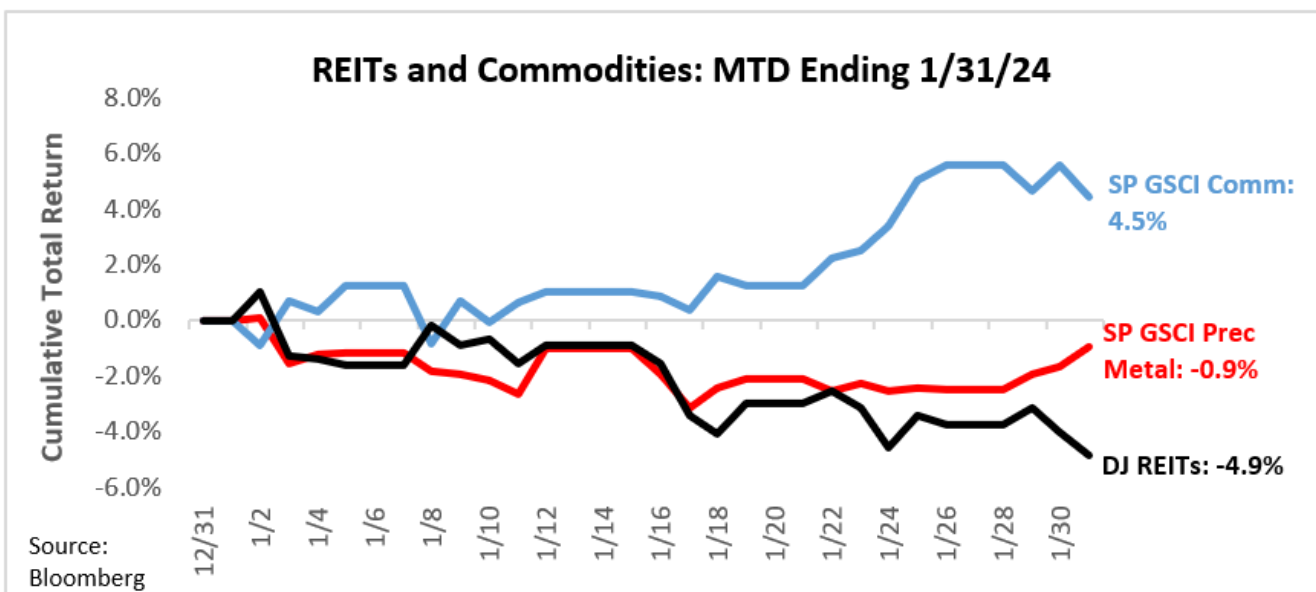
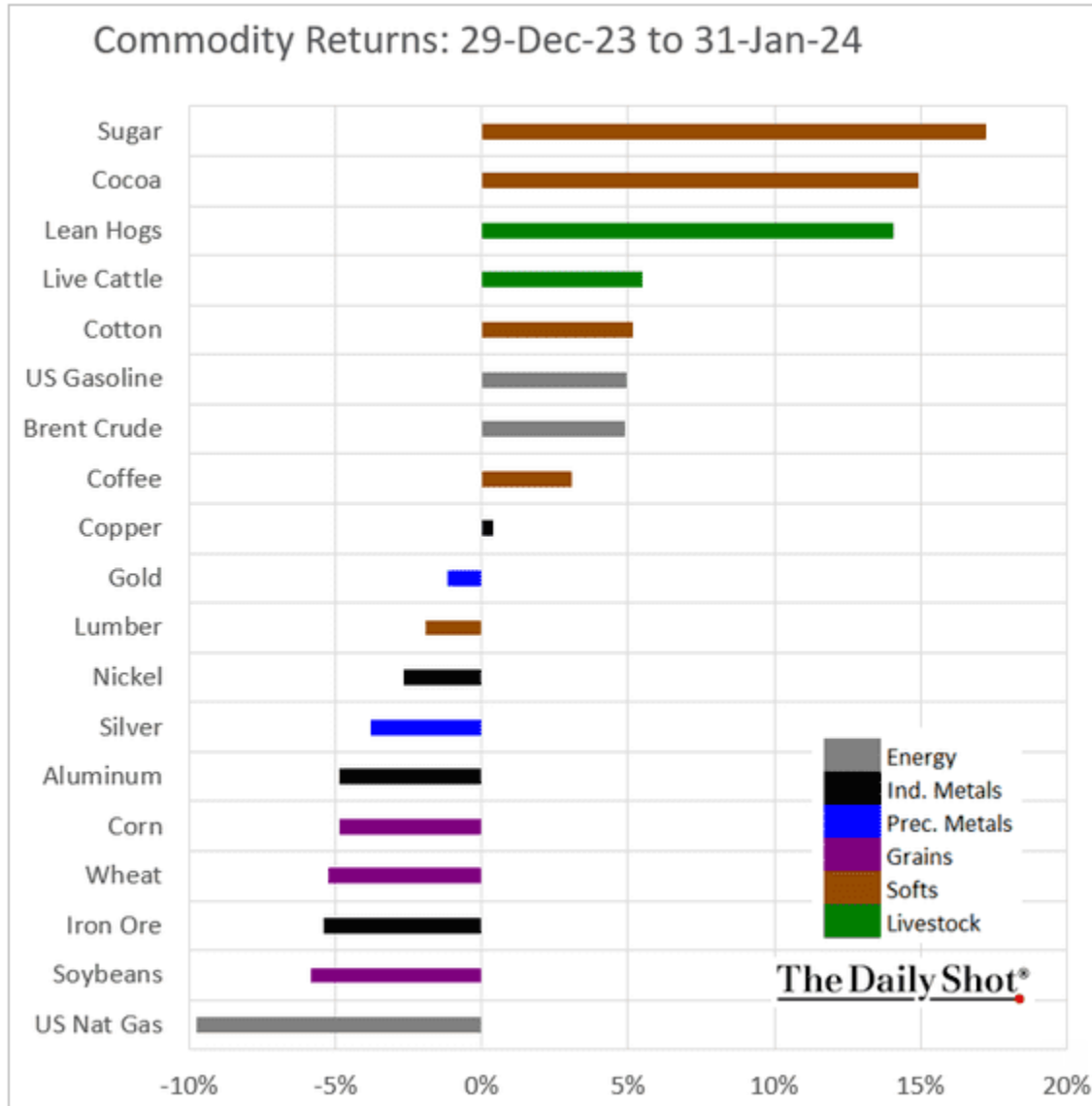


Figure 21 – Specialty Agriculture, Industrial Metals, and Oil/Gasoline Drove This Month’s Positive Gains in Commodities





# FREEDOM

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## INVESTMENT MANAGEMENT

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