November 20, 2023

MARKET SIGHT LINES

Markets Recover on Inflation Relief: 2023 Is Proving to be Quite a Ride

By Michael O'Keeffe, *Chief Investment Officer*

The recent October inflation reports showed progress. Sometimes it is tempting to focus in on one issue, one report, and the immediate market reaction. But 2023 has been filled with a variety of such reports and events that have driven market direction. Taking a step back, the U.S. stock market posted strong returns in the first half of the year, then declined, and more recently it has recovered. Factors at play include persistent inflation, restrictive Federal Reserve (Fed) policy, higher interest rates, a stronger-than-expected U.S. economy, and conflict in the Middle East. Below the surface, performance has been dominated by bigger tech-related companies.

In this Sight|Lines, we briefly review the market dynamics in 2023 and share some details about cooling inflation.

THE TAKEAWAY: THIS YEAR U.S. STOCKS MOVED HIGHER, LOWER, AND NOW HIGHER AGAIN, MOST RECENTLY ON SOME INFLATION RELIEF.

Various forces have driven U.S. equity market performance in 2023, with relief kicking in in recent weeks, increasing the potential for a good year overall. In summary:

- In 2023, U.S. stocks moved higher through the end of July, driven by the hope for cooling inflation, anticipation of the end of Fed rate hikes, and an economy holding up better than expected.
- Then worries began to surface given mixed messages from Fed officials, a resurgence of inflation, market interest rates moving higher, and the stock market falling.
- There was mixed news in October, with a Hamas invasion of Israel and strong third quarter U.S. GDP.
- And since the end of October, markets have recovered, driven by the increasing view that the Fed might be done hiking rates, inflation appears to be cooling, and market interest rates are falling.

As is often the case, various forces are driving the stock market short term, both positive and negative. The most recent move has been in the positive direction, setting up for the possibility of a strong return in 2023 overall.

IN-DEPTH: AN INITIALLY STRONG 2023 U.S. STOCK MARKET GAVE WAY TO A CORRECTION. BUT WE NOW SEE RECOVERY ON NEWS OF COOLING INFLATION AND LOWER RATES.

Various forces have driven U.S. equity market performance in 2023, with relief kicking in in recent weeks, increasing the potential for a good year overall. Going deeper:

- In 2023, U.S. stocks moved higher through the end of July:
  - The S&P 500 returned 20.6% through July 31.
  - U.S. GDP grew 2.2% in first quarter and 2.1% in second quarter, better than expected.
  - We saw progress on cooler inflation, with the Consumer Price Index (CPI) averaging 0.16% in the three months ended July, giving hope that the Fed could soon end its rate hikes.

- Since the end of July, the stock market fell, driven by several factors:
  - The S&P 500 fell 9.9%% from July 31 to October 27.
  - Inflation moved higher, with CPI up 0.6% in July and 0.4% in August, worrying investors.
  - Fed officials continued to signal the possibility of more rate hikes.
  - Fitch Ratings lowered the credit rating of U.S. government debt, and Congress narrowly averted a shutdown with the passing of a stopgap bill.
  - The 10-year Treasury yield rose from about 4.0% to as high as 5.0% during this period.
  - At the end of this period, we saw mixed news in October:
    - On October 7, Hamas invaded Israel, increasing worries of higher oil prices and inflation.
    - On October 26, we learned the first estimate of 4.9% for U.S. GDP, reinforcing confidence in a "soft landing" despite the restrictive Fed policy in place.
- And since the end of October, markets have recovered:
  - The S&P 500 has risen 9.5% from October 27 to November 15.
  - The Fed ended its last meeting on November 1, signaling a stronger possibility of no further rate hikes.
  - October inflation reports show inflation is cooling again. For the month:
    - Headline CPI was flat at 0.0%, and core CPI (excluding food and energy) rose 0.2%.
    - The Producer Price Index (PPI) fell 0.5%, while core PPI (excluding food and energy) was flat at 0.0%.
  - The 10-year Treasury yield has fallen back to about 4.5%.
- Notably, large cap, tech-oriented companies have driven market performance this year:
  - The NYSE FANG+ Index is up 84% year to date through November 15.
    - This index includes Apple, Amazon, Microsoft, and Nvidia, which make up 21% of the S&P 500.
  - The S&P 500 is up 19% year to date, with those companies contributing 90% of that performance.
  - The equal weighted S&P 500, which reduces the weights in these names, is up 4.3% year to date.

CONCLUSION

Various forces are driving the stock market in the short term, both positive and negative. We began 2023 with the U.S. stock market posting strong returns through the first half of the year. But then we saw a decline, with forces including higher inflation, restrictive Fed policy, higher interest rates, a stronger-than-expected U.S. economy, and conflict in the Middle East. But in recent weeks, we've seen recovery on reports of a stronger-than-expected economy and, more recently, cooling inflation.

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