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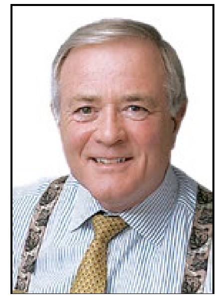
William Rutherford

Financial markets defy pundits and soar to record highs| Opinion

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For much of 2023, economists continued to be doubtful that the Federal Reserve could achieve a reduction in inflation by reducing the money supply and raising interest rates without strangling growth in jobs and the economy. Many analysts were predicting a market sell-off as a result. But in November, the bond market began to sniff out the Fed's success at tightening without sending the economy into a tailspin. The Goldilocks soft landing of not too little, not too much, but just right, was in sight.

Anticipating that the Fed would at last be able to loosen monetary policy, the 10-year Treasury slipped below 4 percent and the markets took off like a rocket for a much-desired year-end Santa Claus rally culminating in a nine-week win streak. The Dow Jones Industrial Average closed out the year up 16.2 percent, the S&P 500 finished up 26.3 percent, and the tech-heavy Nasdaq climbed 43 percent for one of its best performances in two decades.

Tech stocks were led by chipmaker Nvidia and Facebook parent Meta, as investors became more and more confident of the disruptively positive impact of AI. Many consider AI tools to be as strong an economic driver as the advent of the internet and have bid up prices of the related stocks accordingly. As the month progressed, the rally broadened to other overlooked sectors, and analysts believe this trend will continue into 2024. The Nasdaq is now just 6.5 percent below the record high it reached in November 2021.

Lael Brainard, former Fed vice chair and current director of the National Economic Council, maintains that the U.S. economy is strong. Employment is up significantly, unemployment has remained low at less than 4 percent, the annual rate of inflation declined to 3.1 percent in November, yet wages have increased 4.1 percent from a year ago. This means real purchasing power for goods and services has increased for American wage earners.

Payroll employment in 2023 rose by 2.7 million (an average monthly gain of 225,000), with a December gain of 216,000 – much better than the 170,000 expected. December's payroll gains were driven by three broad categories: education/health, leisure/hospitality, and government.

While the November 2023 Consumer Price Index report from the Bureau of Labor Statistics confirmed expectations that headline inflation continues to cool, core inflation that strips out volatile food and energy costs is proving sticky at 4 percent annually. The December and full-year 2023 numbers were reported Jan. 11.

The declines in energy costs and used cars prices have been major contributors to the headline decreases. The median gas price at the pump is below $3, despite global disruptions and wars in key oil-producing countries such as Russia and those in the Middle East. Inflation is even abating in the service sector. The New York Fed's Global Supply Chain Pressure Index (GSCPI) returned to pre-pandemic levels and reached a 26-year low via the biggest drop ever experienced. It was the most significant contributor to the decline in inflation.

On Jobs Friday, the first Friday after the close of the month of December, the unemployment rate reported was below 4 percent. The streak reached 23 months, a span longer than any other in more than 50 years. The increase in jobs coupled with low unemployment and a reduction in inflation indicates a rate cut at the Fed March meeting and perhaps several more later in the year if the statistics continue to be as positive.

Things to worry about include the wars in Ukraine and the Middle East as well as the political turmoil regarding the forthcoming election in the U.S. Russia has already been sparring with Finland and some of its other neighbors, and given Putin's well-publicized ambitions for expanding Russia's geographic hegemony, an event that would require intervention by NATO, and therefore the U.S., is a distinct possibility.

The war between Israel and Hamas with weapons supplied by Iran has caused incidents in other countries and a disruption to the key shipping lanes through the Red Sea. This could mean a return to supply chain disruptions and price increases, not only in Europe but also in the U.S. The Red Sea is a vital area for international trade, with about 15 percent of it passing through its shipping lanes. The Red Sea and the Suez Canal handle 30 percent of the world's shipping container volume.

The financial markets experienced a very bumpy ride in 2023, before closing out with record gains. Shrugging off Fed Chair Jerome Powell's "higher for longer" mantra, traders have priced in six rate cuts by the Fed and the European Central Bank by the end of 2024, which is aggressive. Expect ongoing turbulence. Resist the temptation to try and time the peaks and valleys. History shows that those who invest for the long term in a portfolio of diversified equities benefit from the power of compounding and outperform most of the market timers. When the valleys return, and they will, take your dog for a walk in the woods. Better times have always been around the corner.

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