MONTHLY UPDATE

CARY STREET PARTNERS

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Equity Review and Outlook

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Markets unsurprisingly consolidated over the course of the last month. Unsurprisingly is the operative phrase given the strong nine week run that risk assets experienced through the end of December. Equities as measured by the S&P 500 Index and NASDAQ 100 Index were higher by 1.68% and 1.85% in January. Small caps, as measured by the Russell 2000 were lower by 3.89%. For context, small caps were significant outperformers in late 2023. The Russell 2000 was higher by over 12% in December alone versus the S&P which was up 4.54%. Equities worked off short term widespread overbought conditions during the first few weeks of the year. Both the S&P and NASDAQ 100 have since broken out beyond upside resistance with renewed momentum. The longer-term uptrend is very much intact.

Supply side productivity gains have been the propellent to growth.

In our 2024 Market Outlook, published November 27, 2023, we recommend a balanced growth/value exposure within equities. This is a repeat from 2023. Growth stocks are very long duration equities, with significant revenue growth stretched out for years. As such, these stocks are sensitive to the largest macro input over the last three years, inflation, and dis-inflation, which feed into central bank rate policy. Rapidly increasing rates are why growth stocks stunk in 2022, led last year in anticipation of a policy pivot and have high odds of leadership in 2024.

The epic dis-inflation trend remains in place supported by slightly negative money supply (M2) growth and a dis-inflationary pipeline of shelter data yet to come. Over the last six months ending December 31, core PCE inflation is up 1.86% annualized. Money supply is the cure for inflation just as it was the cause. Inflation data getting to target is all important for Fed policy and markets. Lower CPI and PCE prints will result in the FOMC cutting Fed funds simply to maintain their current stance. The current Fed funds rate of 5.25 to 5.5% suddenly is a very high real rate if inflation is around the 2% target. Lower inflation without cutting is de facto tightening, and while they want to be careful not to cut too soon or too much, they also do not want tighter policy when that policy is already bringing inflation to target.

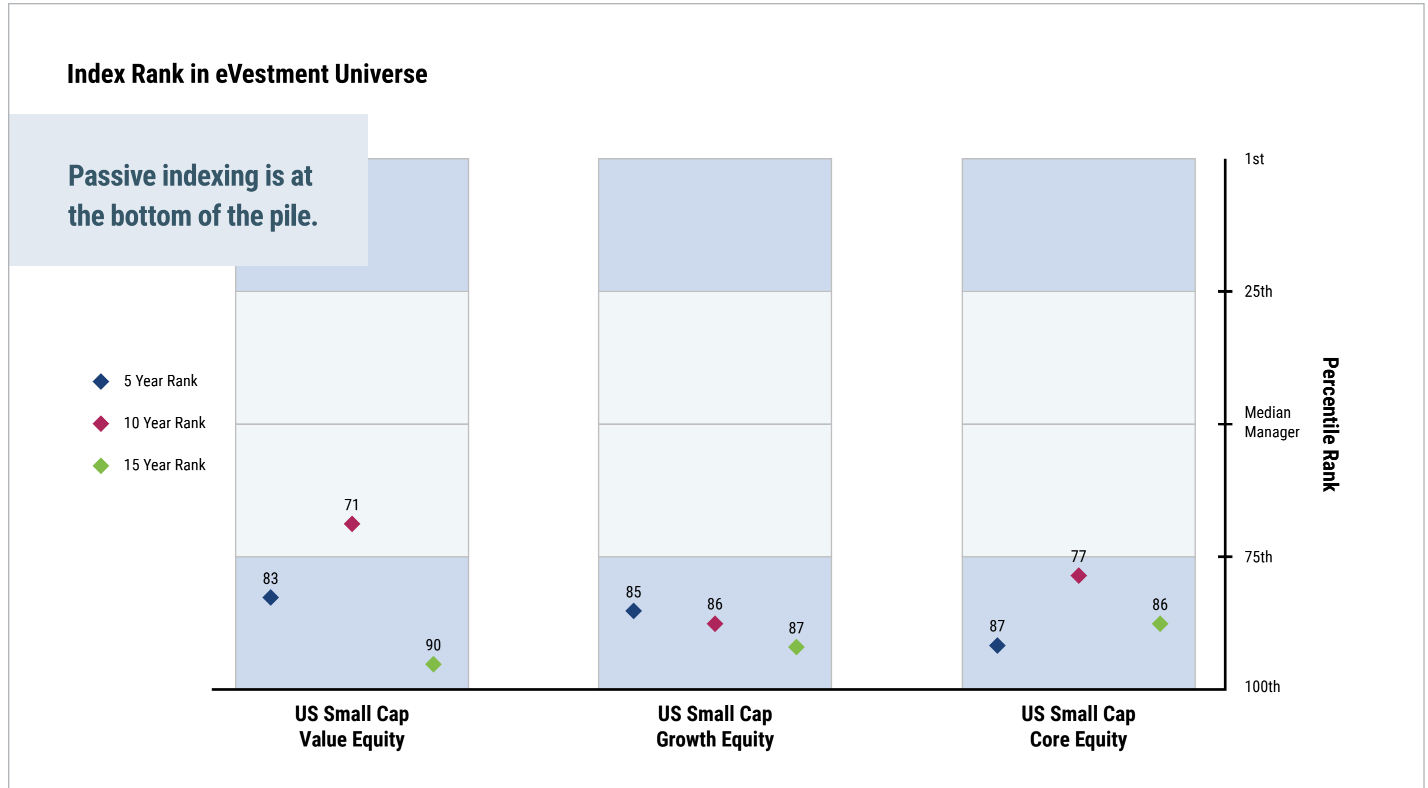
We have never been in the root canal, Phillips curve camp that insists the only route to target inflation is through a recession and higher unemployment. GDP growth and employment have remained robust even as inflation has dramatically improved since peaking in late 2022. Supply side productivity gains have been the propellent to growth. Prime actors in this productivity led growth are normalizing supply chains, a maturing job market characterized by far less churn, and structures-related investment spurred by infrastructure investment.

STILL TIME FOR SMALL CAPS

In the 2024 Market Outlook, and a related Asset Management Viewpoint last September, we recommend exposure to small caps. Investors looking to increase equity exposure should focus dip buying in this portion of the market. Long term, odds of higher potential returns in this market capitalization are very strong. We base that viewpoint on a regression analysis of historical price to earnings multiples versus subsequent returns.

Small caps are also the place where active management can add some value. With ever increasingly efficient markets, it is very difficult for money managers to outperform in larger capitalization.

Very few do so in a persistent manner. The data is overwhelming in support of this point. The market is far less efficient in smaller capitalization, information is simply not as ubiquitous and business models not as widely followed as larger companies. Consequently, portfolio managers add value in this space, as supported by data.



Source: Boston Partners

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