First Citizens Wealth™

Making Sense

Basis Points | December 4, 2024

Testing the Tempo

1. Keeping Pace

Over the course of the year there have been plenty of reasons for investors to adopt more cautious outlooks. Interest rates were elevated, inflation stayed too high, and the labor market wavered. All the while, geopolitical tensions loomed large, equity valuations looked stretched, and policy uncertainty remained high. The economy and markets have stayed in rhythm, but the real test will be if they can hold the beat as the tempo quickens. So far they have, and 2024 has not been a year to stay on the sidelines.

2. Greater Expectations

Equity markets continue to march higher. After crossing its 57th all-time high this year (in 242 trading days), the S&P 500 has returned 28% to date. And unlike several months ago, recent equity-market gains have been broad with small-cap stocks rallying 10% in the last month, compared to 6% for the largest firms. There has also been notable sector differentiation since Election Day. The consumer discretionary sector is up 10% compared to 5% for the overall index, while healthcare, the worst performing sector, is down 1%. Volatility across sectors may persist in coming months as markets price potential shifts in US policy on a variety of fronts. That said, we remain constructive on the US equity market over the medium term. Our current 12-month ahead S&P 500 price target is 6,200.

3. Moderating

Interest-rate volatility was elevated in October and early November as bond yields surged on higher growth and inflation expectations. After climbing further following Election Day, yields across the curve have moved down meaningfully in recent weeks as investors appear to have softened their more hawkish views on higher inflation and fewer interest-rate cuts. At 4.2% the 10-year Treasury is at its 12-month average. As with equity markets, we expect interest-rate volatility to persist over the next several months.

4. Deferred Gratification

Investors have shifted their outlook for the Federal Reserve's interest-rate cuts multiple times this year including over the last several weeks. In September, investors expected the Fed to cut rates by 2.5% from their peak by the end of 2025. That number has now fallen to 1.5% following the recent spate of stronger economic data. Fed policymakers will likely cut the overnight policy rate further, but barring a significant downside surprise to the economic outlook they may slow the pace of rate cuts next year or even pause them altogether.

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5. Stalling Inflation

Inflation remains stubbornly above the Federal Reserve's official 2% target. Running at about 2.5%, the recent pace is below longer-term averages but likely still too elevated for policymakers to deliver the several consecutive rate cuts that markets expected a few months ago. Complicating monetary policy decisions further, economic growth has been revised higher, and financial conditions for large companies remain very easy. But while the inflation rate might still be too high, the Fed's policy rate is even higher, and as a result many argue that interest rates are restrictive. Investors and policymakers must determine which signal to follow, and this will continue to drive uncertainty and volatility.

6. Wild Card

The labor market remains difficult to read. On the one hand, unemployment is up, and more consumers are reporting that jobs are harder to find. Fewer workers are quitting voluntarily, suggesting prospects are not quite as abundant. But it is unclear whether one ought to focus on the recent direction of the labor market (cooling off) or its current state (still quite strong). Markets and policymakers will be paying close attention to the monthly labor reports – including Friday's – for the latest signals. After all, it was the surprisingly strong October 4 jobs report that jolted interest rates higher.

7. No Room for Error

Businesses and investors have quickly begun to position for post-election policy changes, particularly around taxes and international trade. Congress will likely take up tax policy in 2025, given that many provisions of the 2017 tax reform are poised to expire. Republicans will have unified control of government next year, but their majorities in Congress will be narrow, particularly in the House of Representatives where they will govern with one of the slimmest margins in history. As a result, the legislative process next year may be bumpy. Changes to trade policy could be more straightforward, however, as Presidents have authority to conduct much of tariff policy unilaterally.

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