



MORNING BRIEFING

January 3, 2024

A Fifth Year Of Living Dangerously

Check out the accompanying [chart collection](#).

Executive Summary: Despite all the investment perils of the past four years, the S&P 500 rose nearly 50% since the decade began. At this point, investors seem carefree, which worries us. We're monitoring four clear and present dangers that investors seem to be shrugging off: a more hawkish Fed than investors expect, paralyzing partisanship in Congress, the Middle East war, and China's aggressive ambitions concerning Taiwan. ... Also: Joe reports on Standard & Poor's annual reclassification of companies into indexes. Now all of the MegaCap-8 stocks reside again in the Pure Growth index after seven had been ousted a year earlier.

Weekly Webcast. If you missed Tuesday's live webcast, you can view a replay [here](#).

Strategy I: Come What May. The Roaring 2020s has been a wild decade so far. During 2020, we all had to deal with the first wave of Covid. During 2021, we had to deal with another wave or two of Covid. During 2022, Russia invaded Ukraine, inflation soared, and the most widely anticipated recession of all times remained widely anticipated.

During 2023, that same story played out for most of the year but with a few additions: The Gaza War has been raging since October 7, 2023. China fell into a recession and repeatedly threatened to invade Taiwan. And of course, Fed policy was criticized by some for being too easy during the pandemic and then too tight (or not tight enough) as interest rates soared by 500bps or more, fueling fears of persistent inflation and a recession. There was one important difference between 2022 and 2023: Inflation moderated significantly during the latter year, heightening expectations that the Fed is done tightening and would be easing this year.

Yet during those four dangerous years, the S&P 500 advanced 47.6% from the end of 2019 through the end of 2023 ([Fig. 1](#)). Currently, investors seem to be carefree. Their mantra seems to be: "We have nothing to fear but fear itself." Last year ended with a burst of optimism among stock market investors that triggered a powerful rally ([Fig. 2](#)). (Our mantra during carefree times like now is: "We have nothing to fear but nothing to fear.")

At the start of last year, it was widely expected that the stock market would remain in a bear

market during the first half of the year and rebound during the second half. At least that was the widely reported view of some of Wall Street's leading investment strategists. The reverse happened: The S&P 500 rallied during the first half by 19.5%, fell into a 10.3% correction from July 31 through October 27, then experienced a meltup through the end of the year for a gain of 24.2%. When it had nearly achieved our year-end target of 4600 as early as July 31, we concluded that the remainder of the year might see the rally stall for a while.

This year, we wouldn't be surprised if the S&P 500 stalls during the first half of the year and then rallies to 5400 by the end of the year.

Here are a few of the clear and present dangers that we will be monitoring in coming days:

(1) *Hawkish Fed talk*. Odds are that Fed officials will start the new year by trying to lower expectations for rate cuts this year. At the end of last year, the 12-month federal funds rate futures yield was down to 3.95% ([Fig. 3](#)). That implies five 25bps cuts in the federal funds rate by the end of this year. The FOMC's December [Summary of Economic Projections](#) implied three such reductions.

The stock and bond rallies since late October might have discounted an easier monetary policy this year than Fed officials are likely to deliver. That's even if the inflation rate drops down to their 2.0% target ahead of schedule ([Fig. 4](#)). They will continue to be data dependent. As long as the unemployment rate remains below 4.0%, they are likely to hold off on easing, in our opinion. That's because their worst nightmare would be a rebound in inflation.

Fed easing cycles are most pronounced during recessions. We don't expect a recession this year nor do we expect that the Fed will have to ease significantly to avert a recession. The federal funds rate is inversely correlated with the unemployment rate, which we expect will remain under 4.0% at least during the first half of this year ([Fig. 5](#)). If inflation continues to fall toward the Fed's 2.0% target and the jobless rate rises above 4.2%, then a more aggressive easing policy is likely.

(2) *Partisan paralysis and the bond market*. A more immediate concern for investors is likely to be more partisan paralysis in Congress. Republicans and Democrats can agree on fewer and fewer issues. There is also paralyzing partisanship within each of the two parties. The two (or more) sides need to agree on 2024 spending targets over the next few weeks. Republican conservatives are insisting that they will not agree to spending legislation and

military aid to Ukraine and Israel without the passage of a major immigration reform bill.

Meanwhile, we—along with other financial market economists—will be tracking the ballooning federal deficit, led by soaring interest payments on the federal debt ([Fig. 6](#)). All market participants will be watching the results of the Treasury auctions to see whether the Treasury's supply of notes and bonds is overwhelming demand, resulting in another backup in yields like the one that occurred from August to October last year.

When Janet Yellen was Fed chair from 2014 to 2018, we often referred to her as the “Fairy Godmother of the Stock Market.” We noticed that stock prices tended to rally following her speeches and testimonies on the economy. She has been Treasury secretary since 2021. We may start calling her the “Fairy Godmother of the Bond Market.”

That's because the rally in the bond market at the end of last year was sparked by the November 1 Treasury announcement that less would be raised in the note and bond markets and more in the bill market to finance the government's deficits. Indeed, over the past 12 months through November, the net increase in Treasury bills versus notes plus bonds was \$1.9 trillion versus \$0.4 trillion ([Fig. 7](#)). Let's hope Yellen's magic wand continues to work.

(3) *Middle East war.* The Gaza war seems to be turning into a regional war. The latest incident occurred Sunday morning, when Yemen's Houthi militants, in four small boats, approached the Singapore-flagged, Danish-owned Maersk Hangzhou and exchanged fire with a security team onboard. After the militants fired on US helicopters that answered a distress call from the ship, the helicopters returned fire, sinking three of the four Houthi boats and killing their crew members. Iran responded by sending a warship into the Red Sea.

So far, the conflict and rising tensions in the Middle East have had no impact on the price of oil, which has been weak since last fall ([Fig. 8](#)). Supply remains ample, while demand remains weak in China and Europe because both are in recessions.

(4) *China and Taiwan.* China's purchasing managers' index (PMI) fell to 49.0 in December from 49.4 the previous month, an official factory survey showed on Sunday ([Fig. 9](#)). The new orders sub-index was at 48.7, contracting for the third month. Weak external demand remained a major drag on factory activity, with the new export orders index registering 45.8 in December, contracting for the ninth straight month. The sub-index of factory gate prices was at 47.7, contracting for a third straight month, adding to signs of deflation and pressure

on business profits. The official non-manufacturing PMI, which includes services and construction, rose to 50.4 from 50.2 in November, supported by a recovery in the vast services sector.

A weak economy should cause China's government to hold off on any planned invasion of Taiwan. Nevertheless, Chinese President Xi Jinping on Sunday pledged Beijing's "reunification" with Taiwan in his year-end address, just weeks before the self-governing island holds elections for its president and legislature.

Strategy II: S&P 500 Growth Gets a Lift. In late December 2023, Standard & Poor's released new constituents for its various S&P Growth and Value indexes after its annual recalculation of component companies' growth and value scores. Their scores determined which companies appear in which index—Growth, Value, or both (in a weighted fashion)—and which meet S&P's stricter criteria for inclusion in the Pure Growth and Pure Value indexes.

I asked Joe to dig deeper to see what really happened after the close of business on December 20, 2023. Here's his report:

(1) *The changes were stunning for a second year in a row.* At year-end 2022, S&P booted all but one MegaCap-8 stock out of the Pure Growth index. As of year-end 2023, those seven stocks have round-tripped back into Pure Growth.

Specifically, Apple was the only MegaCap-8 company left in the Pure Growth index after the year-end 2022 changes, and these four had been reclassified into both the Growth and Value indexes: Alphabet, Amazon, Meta, and Tesla. Now they're no longer part of the Value index but reside in the Pure Growth and Growth indexes. Their reclassification is understandable since price momentum and sales growth are a big part of the Growth score, and theirs rebounded sharply in 2023 after deteriorating considerably in 2022.

(2) *Pure Growth price underperformed in 2023 due to MegaCap-8's absence.* The ejection of seven of the MegaCap-8 stocks in 2022 from the Pure Growth index caused that index to underperform Growth considerably in 2023. During 2023, Pure Growth rose 6.5%, well behind the 28.3% gain for Growth. However, both those performances were better than the 5.3% and 19.8% gains for Pure Value and Value. The S&P 500 rose 24.2% last year.

A year earlier during 2022, all of the MegaCap-8 stocks were in the Pure Growth index before being removed near the end of that year. Pure Growth fell 28.1% in 2022, slightly

better than the 30.1% decline for Growth, but both indexes performed considerably worse than the 3.3% and 7.4% declines for Pure Value and Value. The S&P 500 was down 19.4% in 2022.

(3) *Now and then: A look at the MegaCap-8's style classifications.* Recall that the S&P 500 Growth and Value indexes are further analyzed to determine which companies exhibit scoring characteristics of both Growth and Value and are weighted in each of those indexes by their scores. Now meeting the criteria to appear in both indexes are 161 of the S&P 500 companies, up from 135 companies a year earlier. Here's how the MegaCap-8 companies have been classified during the past three years:

Current MegaCap-8 classification in S&P 500 Growth/Value indexes (end of 2023):

Pure Growth & Growth: Alphabet, Amazon, Apple, Meta, Microsoft, Netflix, Nvidia, Tesla

Growth only: None

Both Growth & Value: None

Value only: None

Pure Value: None

Prior MegaCap-8 classification in S&P 500 Growth/Value indexes (end of 2022):

Pure Growth & Growth: Apple

Growth only: Netflix, Nvidia, Tesla

Both Growth & Value: Alphabet, Amazon, Meta, Microsoft

Value only: None

Pure Value: None

Prior-prior MegaCap-8 classification in S&P 500 Growth/Value indexes (end of 2021):

Pure Growth & Growth: Alphabet, Amazon, Apple, Meta, Microsoft, Netflix, Nvidia, Tesla

Growth only: None

Both Growth & Value: None

Value only: None

Pure Value: None

(4) *The Pure Growth constituents then.* Here's what happened to last year's old top-eight constituents by market capitalization among the 73 companies then in Pure Growth: Apple (remains in Pure Growth), Exxon Mobil (back to Value), UnitedHealth (back to Growth and Value), Chevron (back to Pure Value), Eli Lilly (remains in Pure Growth), Merck (back to Growth and Value), AbbVie (back to Growth and Value), and Pfizer (back to Value).

The MegaCap-8 once again occupies the top seven spots in the Pure Growth index, just as it did at the end of 2021. Netflix ranks just outside the top ten.

(5) *The Pure Value constituents now.* The current top-eight market capitalization companies of the 99 Pure Value companies are: Berkshire Hathaway, Chevron, Bank of America, Wells Fargo, Verizon, Goldman Sachs, AT&T, Elevance Health, and CVS Health.

(6) *Big changes in forward valuation and profit margin measures.* S&P's changes to the style indexes caused the forward P/E for S&P 500 Growth and Pure Growth to rise sharply relative to their Value counterparts. Pure Growth's forward P/E soared that day to 20.5 from 15.4, Pure Value's dropped to 9.8 from 10.4, Growth's jumped up to 25.5 from 21.5, and Value's fell to 15.3 from 17.4 ([Fig. 10](#) and [Fig. 11](#)).

The level of forward revenues and earnings changed drastically too. However, among the various indexes' forward profit margins, only Growth's changed materially, rising to 18.3% from 16.3%, while Value's ticked down to 10.4% from 10.6% ([Fig. 12](#)).

(7) *Addendum: Uber now in the S&P 500.* When S&P reconstituted its style indexes in December, it added Uber to the Pure Growth index of the S&P LargeCap 500 index. With a total market capitalization of \$126 billion, Uber currently ranks as the 15th largest company in the Pure Growth index and the 67th biggest company in the S&P 500. Uber, which soared 149% last year, is the only member of the S&P 500 Industrials sector's Passenger Ground Transportation sub-industry, which was created last year in March.

Calendars

US: Wed: ISM M-PMI & Price Index 47.1/47.5; Job Openings 8.80m; MBA Mortgage Applications; Weekly Crude Oil Inventories; FOMC Minutes; Barkin. **Thurs:** ADP Nonfarm Employment Change 113k; Initial & Continuous Jobless Claims 215k/1.882m; S&P Global Composite C-PMI & NM-PMP 51.0/51.3; Crude Oil Inventories & Gasoline Production. (FXStreet estimates)

Global: Wed: Germany Unemployment & Unemployment Rate 20k/5.9%; Japan M-PMI 47.7. **Thurs:** Eurozone, Germany, and France C-PMIs 47.0/46.7/43.7; Eurozone, Germany, and France NM-PMIs 48.1/48.4/49.8; Germany CPI 0.2%_{m/m}/3.8%_{y/y}; France CPI 0.3%_{m/m}/42%_{y/y}; UK C-PMI & NM-PMI 51.7/52.7. (FXStreet estimates)

Global Economic Indicators

Global Manufacturing PMIs ([link](#)): The December survey revealed global manufacturing activity ended 2023 on lackluster footing. The *JP Morgan Global M-PMI* ticked down from 49.3 in November to 49.0 in December, the 16th consecutive month below the breakeven point of 50.0—making this the longest sequence of deterioration since the downturn from December 2000 to February 2002. The report notes that December saw production decline for the seventh consecutive month as intakes of new business suffered a further contraction. As demand weakened, producers once again relied on completing backlogs of work to support output. By country, only seven of the 29 countries for which data are available registered growth in December: China, Colombia, Greece, Indonesia, Mexico, the Philippines and Russia. US manufacturing output contracted for the first time in four months, while Japan recorded its seventh straight month of declines. The Eurozone remained the main source of weakness, with downturns in Germany, France, Austria, and the Netherlands severe. Other European nations showing marked contractions were the UK, Poland, and Czechia. Inflationary pressures continued to edge higher in December, though both input and output costs remained relatively mild.

Contact us by [email](#) or call 480-664-1333.

Ed Yardeni, President & Chief Investment Strategist, 516-972-7683
Debbie Johnson, Chief Economist, 480-664-1333
Joe Abbott, Chief Quantitative Strategist, 732-497-5306
Melissa Tagg, Director of Research Projects & Operations, 516-782-9967
Mali Quintana, Senior Economist, 480-664-1333
Jackie Doherty, Contributing Editor, 917-328-6848
Valerie de la Rue, Director of Institutional Sales, 516-277-2432
Mary Fanslau, Manager of Client Services, 480-664-1333
Sandy Cohan, Senior Editor, 570-228-9102

Copyright (c) Yardeni Research, Inc. Please read complete [copyright and hedge clause](#).

