Mountain Pacific Investment Advisers
877 Main Street, Suite 704
Boise, Idaho 83702
(208) 336-1422

William J. Palumbo
Bruce A. Reeder
Matthew M. Lindstrom
Nathan C. Oakley

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After enough study of securities and investments, one overarching principle of finance becomes clear: **the price of any financial asset equals the sum of the present value of its expected future cash flows.** Several key terms in this simply stated axiom can bedevil the financial practitioner, but the word "expected" probably holds the greatest sway. Indeed, a review of recent market history provides great examples of the central role market expectations play in understanding gyrations in asset prices.

As the country began to normalize after the depths of Covid, the general price level of goods and services started to increase in early 2021. Having not been a serious concern since the early 1980s, this increase in inflation really got the attention of markets and of the Federal Reserve. Economists at the Fed debated whether to enact the conventional response to inflation, raising the Federal Funds rate, or whether to let the problem resolve itself as the nation adjusted to a post-Covid "normal". Due largely to the unprecedented imbalances in both aggregate supply and demand wrought by shutdowns and possibly the sheer novelty of inflation after so many years of stable prices, Fed officials concluded as early as the April 2021 Federal Open Market Committee (FOMC) meeting that higher inflation was "largely reflecting transitory factors" and so decided not to raise rates.

Interestingly, market expectations due to the Fed's stance differed across asset classes. Equities, which generally thrive in low or stable rate environments, seemed to take at face value the commitment to stable rates; stocks rose steadily through the year with the S&P 500 peaking at 4,796 on January 3, 2022. The bond market, however, sensed the Fed's mistake. The ten year US Treasury note price fell as its yield rose 0.60% (60 basis points) from 0.91% to 1.51% during the year as the bond market priced in expectations that higher rates might be necessary to tame inflation.

As the consumer price index rose from under 2% to 7% during 2021, the Fed kept the Fed Funds rate constant at the 0%-0.25% range, sticking to its party line until late November when Chairman Powell abashedly conceded that "…it's probably a good time to retire that word (transitory)…." With this admission, the Fed then got serious about controlling inflation.

During all of 2022, expectations about the pace of rate hikes actually worked against the market. The post-1982 era of quiescent inflation had accustomed investors to gradual increases in the Fed Funds rate, typically of 25 basis points per meeting. The Powell Fed of 2022, however, shocked markets with seven rate hikes, including four of 75 basis points and two of 50 basis points, trying to clamp down on surging inflation which would peak at 9.1% in the middle of the year. Stock and bond investors drove the prices of both assets down as they recalibrated their expectations to a Fed on "war footing" for the first time in almost 50 years. By the October low, the S&P 500 had lost 24%, hitting 3,577 and the ten year US Treasury note had lost about 20%, its yield rising almost 275 basis points to 4.24%. Coinciding losses in asset classes that typically offset one another in times of low inflation made 2022 especially painful for investors.

By early 2023, the main focus of the market had shifted to expectations of the end of the rate hike cycle. The Fed slowed the pace of rate increases as it tried to gauge the likelihood that inflation would continue to slow. The final hike (as of this letter, anyway) was at its late July meeting. The rate of inflation continued to ease. Labor markets were a source of economic support, prompting earlier widespread expectations for recession to give way over the year to the sanguine assumption currently in effect that the Fed will achieve a "soft landing", that is, a rate hike cycle that does not end in recession.

In November and December, benign economic data and Fed commentary confirming a shift to anticipating future rate cuts validated investors' soft landing expectations. This supercharged the market impact, driving the S&P 500 up 14% to 4,770 and the 10 year US Treasury price up about 8% (yields fell 105 basis points to 3.88%), a huge move in only two months. The S&P 500 is now flirting with the peak level achieved two years ago before the Fed began its campaign to rein in inflation.

Stepping back, despite the power of market expectations to drive asset prices, the example of 2022 and others show there is no guarantee that those expectations will be proven correct. Will the Fed indeed pull off a soft landing? History votes this unlikely even as the current situation looks hopeful.

Risks abound on both sides of the tightrope the Fed is currently walking. On one side, the Fed recognizes that it is too early to know if its policy actions will be sufficient to bring inflation back to its 2% long term target; more hikes might be necessary. The labor market, a linchpin of inflation, continues to show resilience. Ironically, the euphoric fourth quarter market response to expectations of imminent rate cuts loosened general financial conditions, thereby stimulating the economy and actually heightening the risk that more rate increases will eventually become necessary to quell inflation. To a market already expecting almost 150 basis points of rate cuts in 2024, a resumption of hikes would be a nasty surprise.

On the other side of the Fed's tightrope lies the vastly more typical outcome to an aggressive rate hike cycle: recession. A variety of leading economic indicators with a track record of predicting recessions such as the slope of the yield curve (the difference in yields between shorter and longer dated US Treasury bonds) and bank lending surveys point to recession. The question, however, is when. Higher interest rates only impact the economy over time and after a lag that can vary greatly in length. Complicating an estimate of the lag is the lack of precedent for the Fed's ongoing shrinking of its balance sheet and decreasing of the money supply through run-off of its bond portfolio, a process called quantitative tightening (QT).

This year should be an interesting one because, needless to say, the outcomes for the economy and the market are still quite uncertain. A benefit of the measured, long-term approach we take to investment management and stock selection, however, is that it is designed to buffer large swings in the macroeconomy. In fact, we have found that junctures like the current one are the best time to "stick to the plan".