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The four trends driving financial markets in 2024

The Standard & Poor's 500 Index (S&P 500) is a snapshot of the market. Yet every once in a while, that snapshot can get a little distorted. Investors must zoom in on just a few pixels to get a clearer view, and that's what's happening today.

U.S. equities may be off to a strong start this year—the S&P 500 has generated a 6.7%[i] total return—but the rally has been exceedingly narrow. The gains have been driven by the so-called Magnificent 7—Apple, Amazon, Alphabet, Meta, Microsoft, Nvidia and Tesla. Those stocks are up an average of 10.4% this year.

In this piece, we highlight four important investment trends that have shaped the first two months of 2024, as observed by our senior investment leaders. The biggest trend is the story of the Magnificent 7—companies that are propelling the artificial intelligence (AI) revolution while pushing the stock market to new highs.

But first, let's set the scene. As we said, the strong start to 2024 has been driven by a handful of mega-cap technology stocks. The S&P 500 is market-weighted, which means its largest companies exert outsized influence on returns. Were the S&P equal weighted—were the returns of the largest S&P 500 companies given the same weight as the smallest—the S&P would be up a more modest 2.7% year to date. Other big trends we're watching: rising rates for taxable bonds, falling supply for municipal bonds, and still low stock volatility with increasing election related policy uncertainty.

Equity valuations are somewhat pricey. Investor optimism is high, which is typically a contrarian signal leading to weaker returns going forward. That said, valuations tend to be a poor market-timing tool, especially in the near term. We continue to believe that clients should stay the course and remain invested in equities, as the chances of a soft landing have increased because the AI tailwind is strong, and because the Federal Reserve (Fed) is inclined to cut rates eventually (if only to normalize them, not to stave off recession). These are all positive drivers for equities.

Over in fixed income, the U.S. bond market is down 2% year-to-date on a total return basis, as bond yields have pushed higher. Bond yields are up (prices are down) so far this year due to stronger than expected inflation data, the Fed pushing back on the rate cuts the market priced in late last year, stronger than expected economic growth, and some payback from the remarkable rally in the bond market that rounded out 2023. Despite the runup in yields this year, credit spreads have narrowed, reflecting strong demand for corporate debt from borrowers and a better-than-expected backdrop for corporate balance sheets in the early part of 2024.

Looking ahead, GDP growth in the first quarter of 2024 is expected to be nearly as strong 2023's performance. While consumer spending has cooled after a strong holiday spending season, consumer confidence is now getting a boost from lower gas prices and a still favorable job market. Inflation is still moderating, but the path to the Fed's 2% goal is proving bumpy (as we predicted), which may delay monetary easing. On one hand, the Fed is standing at the doorstep of an enviable achievement—a soft landing—one that seemed improbable just a few months back. On the other, the Fed needs to be convinced that inflation is headed towards 2% before it starts cutting rates. This is why we don't expect easing to begin until mid-year. Now, onto our four trends:

The Magnificent 7 and the potential for a small cap rally

Information technology (IT), specifically software, continues to drive market performance, according to **Robert Marshall**, Managing Director, Equity Portfolio Manager for TIAA's Investment Management Group (IMG). The Magnificent 7 single-handedly drove S&P 500 returns in 2023—producing over 90% of the S&P 500's upside—and this trend has continued in 2024. However much helium there may be around AI these days, we do not agree with those who see the AI boom as another late 1990s dot-com bubble. In 2000, the tech-laden Nasdaq Composite Index had a price-to-earnings (P/E) ratio of 100. Today, the Nasdaq's forward P/E is 36.

A recent stabilization in demand trends is improving the prospects of a second wave of tangentially exposed AI names. Also, AI is not the only industry within information technology (IT) boosting secular growth, as cyber security and cloud technology are contributing too. In other words, there are multiple reasons for optimism:

1 Demand for cyber security products is being driven by a mushrooming threat environment. U.S. corporations are experiencing around-the-clock incursion attempts and ransomware threats undertaken by hostile foreign governments and other bad actors. In mid-December, the SEC mandated full disclosure of hacking attempts at publicly traded companies. This is causing a significant upgrade cycle as companies want to avoid reputational damage, as well as the obvious negative effects of data loss and infrastructure damage.

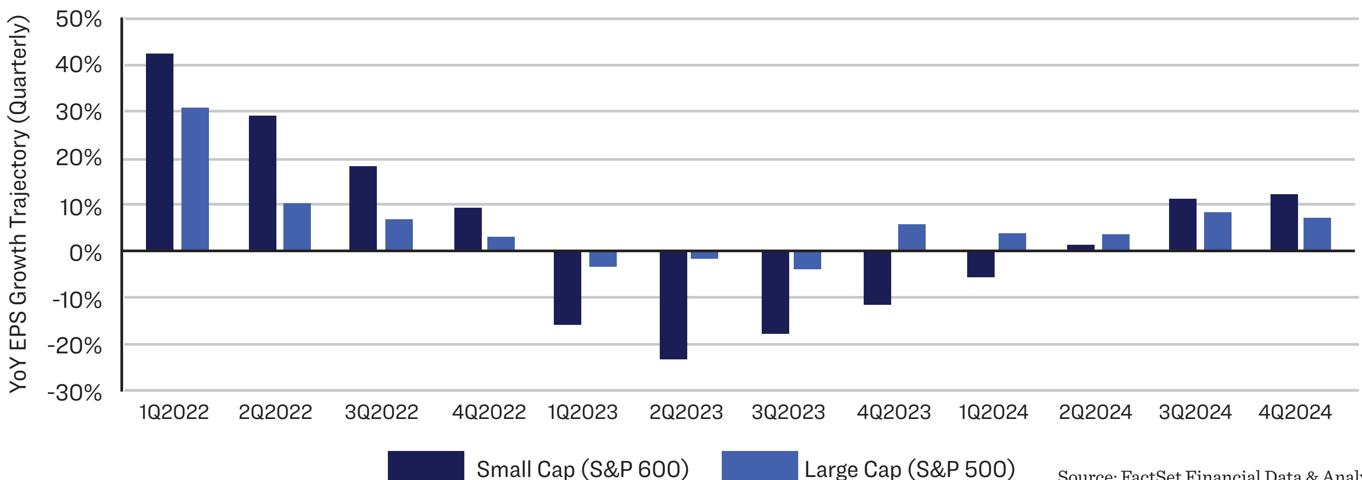
2 Given the significant IT infrastructure cost savings, corporations continue to migrate data to the cloud. Operating in the cloud offers corporations the opportunity for considerable cost savings versus on-site operations. And this spending is still early stage. To use a baseball metaphor, U.S. cloud migration remains in the third or fourth inning. Outside the U.S., it's more like bottom of the first or top of the second.

3 Credible strategists believe that AI will be a bigger event than the advent of the internet. Benefits of AI include process and workflow automation, efficiency gains through the automation of repetitive tasks, better and faster conclusions from big data sets such as drug trials, and AI-enabled personal assistants in areas such as call centers and customer assistance.

The next round of gains by big software stocks should be driven by three factors: still-reasonable valuations, an improving macro environment as the Fed lowers interest rates, and more widespread adoption of AI driving top-line growth across multiple IT sectors in 2024 and beyond. If we do see significant rate cuts in 2024, a small cap rebound could be in the cards too. As we move through 2024, analysts expect earnings from the S&P 600 small cap index to grow faster than those of the large cap S&P 500 (Figure 1). This implies small cap equities should outperform their large cap brethren, especially since small cap stocks are now about one-third cheaper on a P/E basis (Figure 2). Our small-cap enthusiasm does come with caveats though. It's predicated on the Fed easing rates significantly, something that may not happen if inflation takes another turn higher . Also, if the Fed winds up cutting rates in response to a recession, not a soft landing, the odds of small caps outperforming grow smaller.

Figure 1

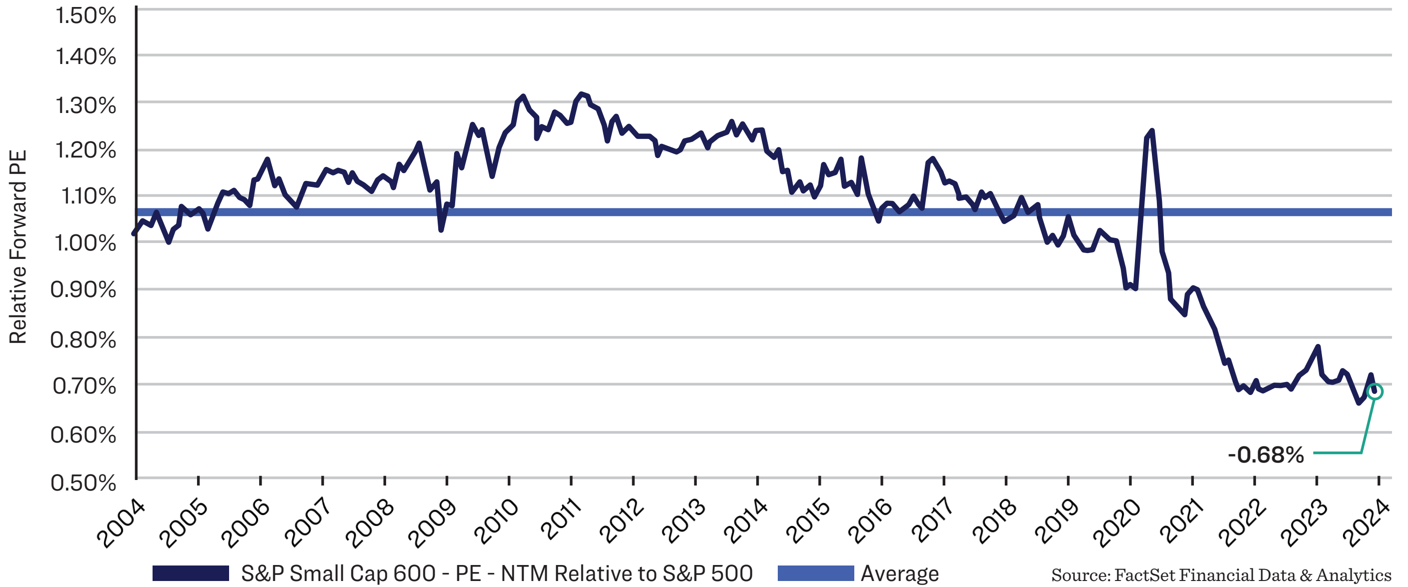
Year-Over-Year EPS Growth Trajectory Looks Favorable For Small Caps



Source: FactSet Financial Data & Analytics

Figure 2

Small Cap Stocks Are Inexpensive Relative To Large Caps



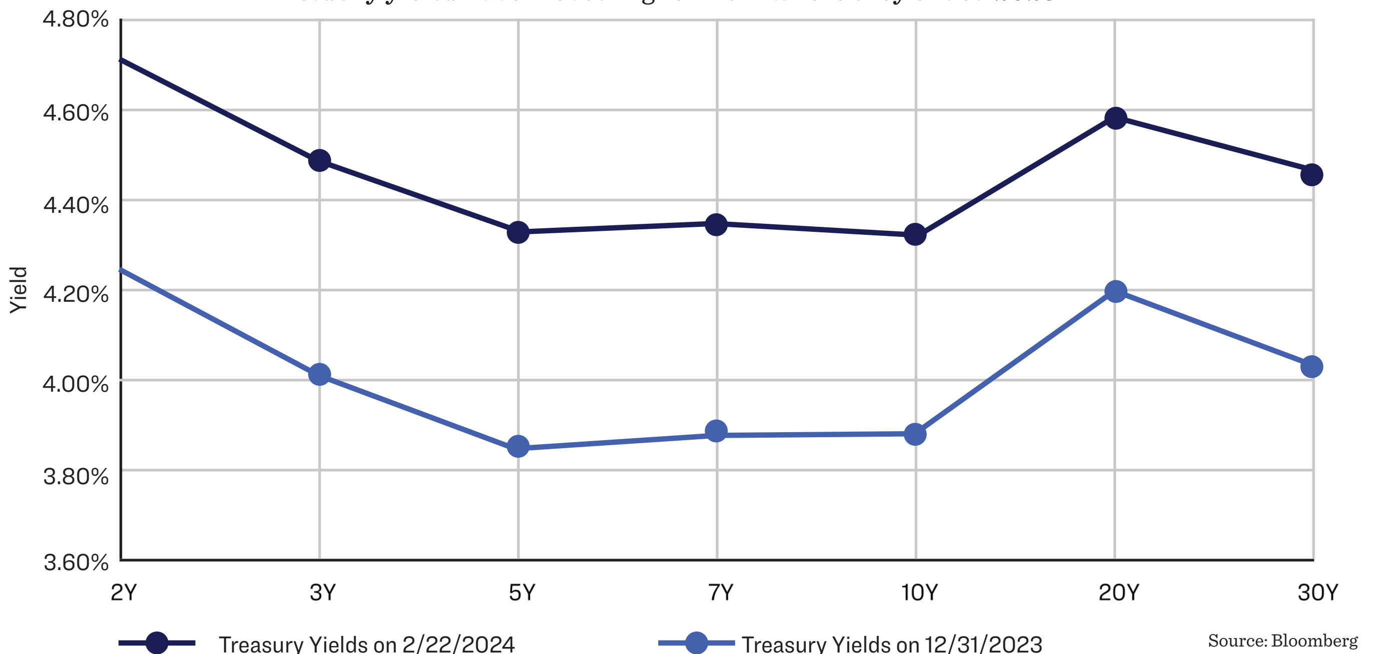
Source: FactSet Financial Data & Analytics

Rising rates for taxable bonds

Yields on Treasury securities have moved higher from where they ended the year in 2023 (Figure 3). According to **Bryan White**, CFA, Director, fixed income portfolio manager for IMG, the path forward for rates has become more uncertain. After reaching 2023 year-to-date highs in October, Treasury yields moved significantly lower during November and December, as the market narrative of “higher for longer” rates shifted abruptly to a “goldilocks” scenario whereby the Federal Reserve would cut interest rates aggressively in 2024. Inflation data was trending downward while the labor market remained resilient, with a sub-4% unemployment rate. At the end of December, the market had priced in Fed rate cuts of over 150 basis points (bps) for 2024, even though the Fed’s median forecast indicated a more conservative path for rate cuts of just 75 bps. The divergence in expectations was primarily attributable to investors’ conviction that the battle against inflation was largely over and that near-term rate cuts would be required to avoid pushing the economy into a recession.

Figure 3

Treasury yields have moved higher from where they ended 2023



Source: Bloomberg

The narrative began to shift in January and to a greater extent in February 2024, as market expectations capitulated to the Fed's 75 bps forecast. This led to higher Treasury yields across the curve. Stronger-than-expected January employment data, as well as several inflation readings that came in above expectations, contributed to the upward move. During recent appearances, Federal Reserve members, including Chairman Jerome Powell, have pushed back against overly optimistic market projections for rate cuts. Minutes from the January Fed meeting revealed that officials are still optimistic about the path of inflation but need further evidence that inflation is contained before starting the easing cycle. Bond market volatility will likely remain elevated in the near to intermediate terms. The beginning of 2024 has reinforced the narrative that interest rates and inflation are not on a linear path downward.

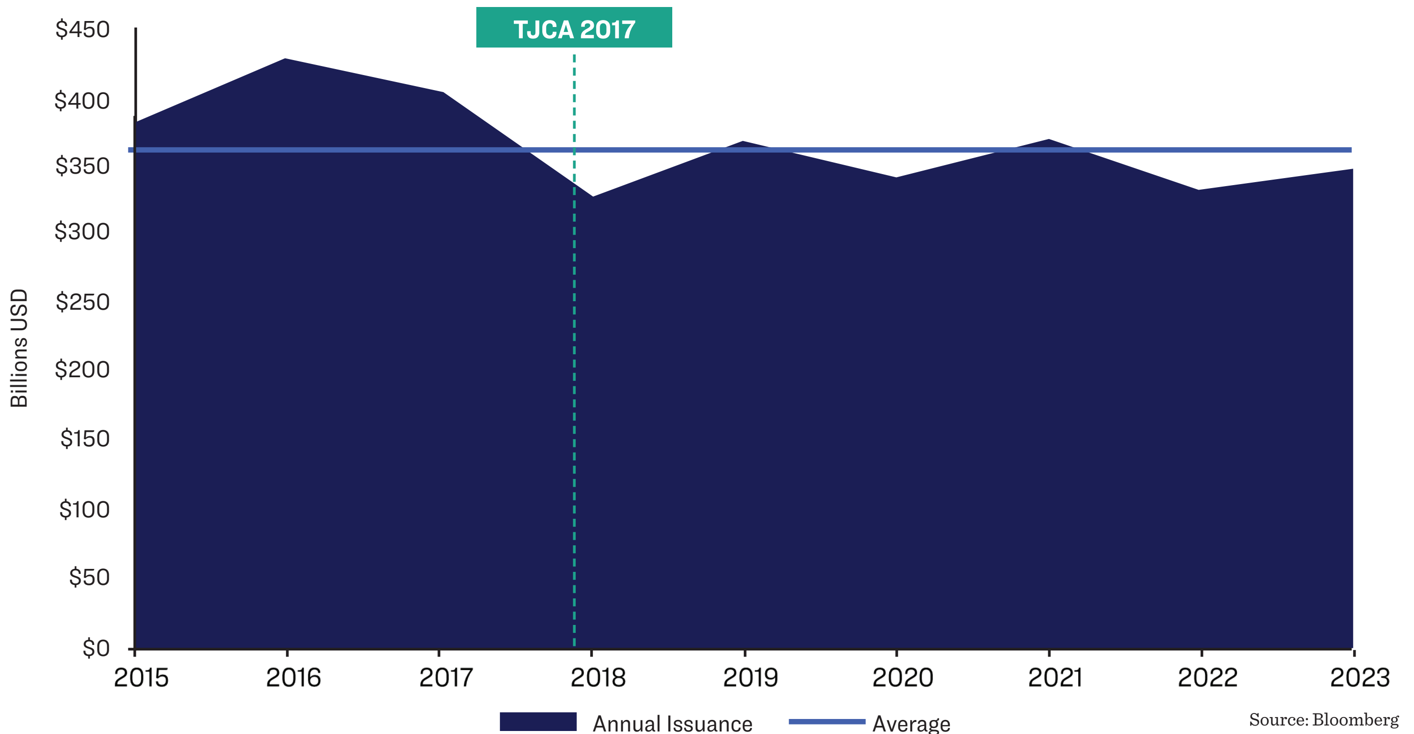
A supply crunch for munis?

The municipal bond market is often subject to seasonal trends in which supply and demand fall out of balance. This year, according to IMG Senior Director of Fixed Income, **Jill Richman**, a lack of supply is responsible for the mismatch. For a third consecutive year, the municipal market has experienced dwindling issuance of new bonds.

While supply in 2023 ended nominally higher than the prior year, it has broadly trended lower in recent years and remains 17% below pre-2017 levels (Figure 4). A significant driver of this decline was the 2017 Tax Cuts and Jobs Act (TCJA), which stripped issuers of their ability to refinance certain outstanding bonds on a tax-exempt basis. More recently, supply has been lackluster due to soaring inflation and the resulting spike in interest rates—which delayed many municipal projects by making them more expensive to pay for. Higher interest rates also contributed to cities and states utilizing reserves, instead of issuing new bonds, to fund projects.

Figure 4

Municipal bond supply has trended lower over the last several years



Source: Bloomberg

Helping offset the impact of the supply decline has been a corresponding drop in demand. Enticed by a strong equity market and spooked by the decline in bond values (bond prices move in the opposite direction of market interest rates), retail investors reduced their allocation to fixed income. Municipal bond mutual funds experienced a record $144 billion in outflows in 2022 and an additional $17 billion in 2023. Institutional demand has also been lackluster as banks and insurance companies trim muni purchases.

However, a shift in this dynamic could become a tailwind for municipal bonds in 2024. While supply is expected to grow modestly, it's likely to remain well below historical averages. Demand, on the other hand, could accelerate as investors now on the sidelines reallocate capital to fixed income as rates stabilize. Additionally, while yields are off their highs, growing expectations of lower interest rates later this year should incentivize investors to move out of cash and other shorter-maturity investments, providing further support for broader fixed income markets. Consequently, municipal bonds could be poised for another year of solid returns and relative performance.

Election-year volatility offers opportunities

Volatility in financial markets often prompts investors to rethink the positioning of their portfolios, according to **John Canally**, CFA, IMG's Chief Portfolio Strategist. But understanding the causes and historical context of volatility can help them make better decisions, stay invested, and remain on track to hit long-term goals.

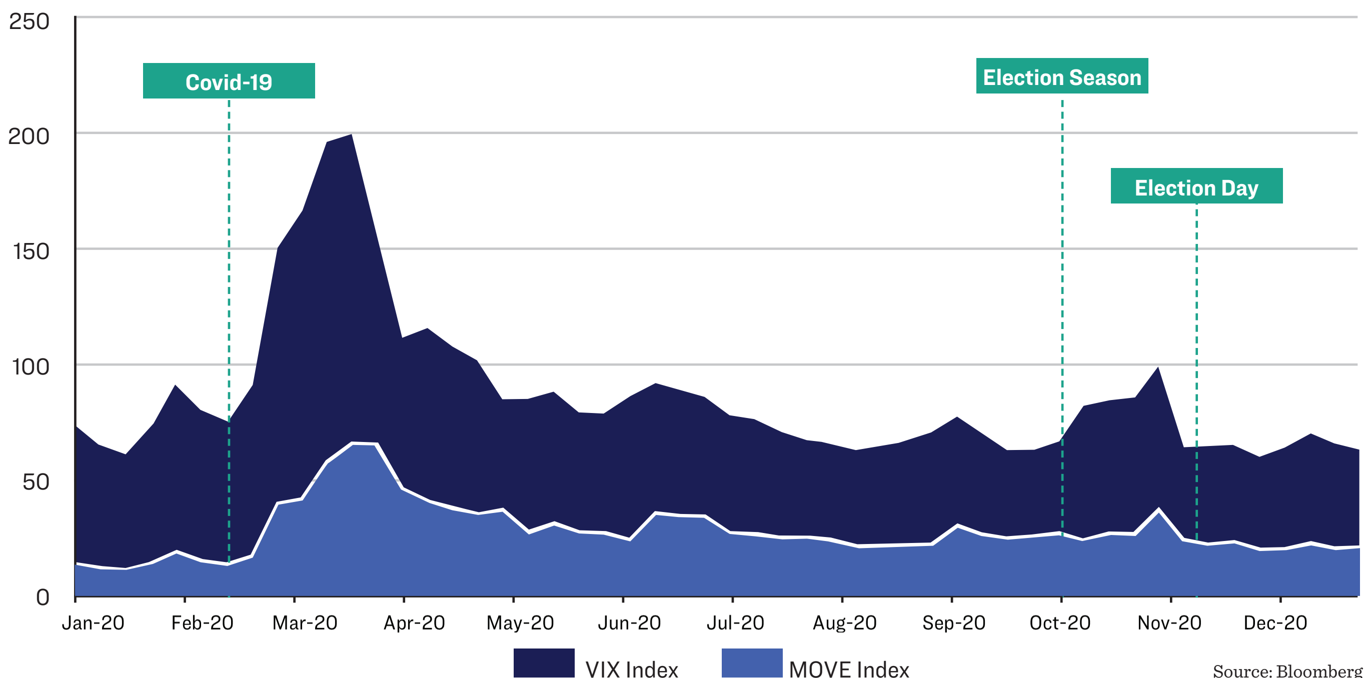
In the first two months of 2024, volatility in U.S. equity and bond markets trended higher. In the equity market, volatility is still below historical averages (as measured by the VIX index). In the bond market, the resurgence in inflation to 40-year highs in 2021 and 2022, along with reverberations from poor performance in 2022 and 2023, left volatility elevated by historical standards (as measured by the MOVE index). And it's been kept high by ongoing uncertainty over the timing and magnitude of Fed rate cuts. Every new data point—a jobs report, a monthly Consumer Price Index announcement or an earnings release from one of the Magnificent 7—seems to lead to large spikes in market movement.

The U.S. election is likely contributing to market volatility as well, if history is any precedent. From 1992 to 2020, volatility in the U.S. stock and bond markets was higher, on average, in presidential election years than in non-presidential election years. Volatility in both stocks and bonds tended to rise in the months leading up to the election, then move lower after Election Day.

This pattern held even in 2020, a year where the election was not the only major event for financial markets. Equity volatility spiked to record highs in February and March 2020 as COVID-19 spread around the world and caused major economic and health disruptions. Bond market volatility hit a 12-year high in March 2020. In the spring and summer of 2020, measures of volatility in both equity and bond markets moved lower, before trending higher in September and October of 2020 just prior to the November election. After the election, volatility eased (Figure 5).

Figure 5

Equity and bond market volatility spiked to record highs in February and March 2020 as COVID-19 spread, and again just prior to the November election. After the election, volatility eased.



Source: Bloomberg

We continue to believe that 2024 will bring episodic market volatility, driven by new inflation data, corporate earnings reports, changes in fiscal and monetary policy, and increased focus on the outcome of the 2024 election. However, our view is that these bouts of volatility in stocks and bonds may present buying opportunities in both asset classes, at least for investors with excess cash and longer time horizons.

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[i] Unless otherwise noted, data cited in this report is sourced via Bloomberg through February 27, 2024

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