We can make arguments for rates easing or remaining high, but what seems clear is that stocks' path in 2024 will be driven by the path of interest rates.

PROPHESY

In the third quarter of 2023 stocks fulfilled the biblical prophesy that the first shall be last and the last shall be first. That is, the handful of super-sized stocks that drove the market up for the first six months of the year—think Apple, Microsoft--dragged it down in the third quarter. And Energy—aka, fossil fuel--stocks, which were in the red during the first half, rose 12.2% in Q3, as Russia and Saudi Arabia throttled back oil supplies to jack up oil prices. Energy stocks follow oil prices.

As a result of skyrocketing oil prices, in Q3 the Energy sector was one of only two S&P 500 sectors that were in the black, the other being Communication Services, up 3.1%. The other nine sectors were all in the red for the quarter.

Now, while the S&P 500 fell 3.3% for the third quarter, it was still up 13.1% for the first nine months of the year. Our Arjuna 350 US stock strategy returned 10.2% for the period, lagging the S&P for two reasons: extremely narrow market breadth in the first half (explained last quarter) and, as fossil-fuel-free investors, being out of the energy sector in Q3.

Similarly, our Arjuna Global Impact stock strategy returned 7.5% for the first nine months of 2023 vs. its MSCI World benchmark's return of 11.1%.

We stand by our policy of avoiding fossil-fuel stocks, not only because they are the poster children for an unsustainable economy, but also because they have been terrible investments over the long-term. For the ten years through September 30, 2023, the Energy sector is dead last in performance among the 11 sectors of the S&P 500, having returned 4.9% per year vs. the S&P 500 return of 11.8% per year over the same period. As we've said before, every dog has its day, but that doesn't mean we want to invest in dogs for the long term.

TINA

While sharply rising oil prices helped Energy stocks and not much else in Q3, the biggest factor in the overall market's pullback was sharply rising longer-term interest rates. For the past decade, the yield on the 10-year US Treasury Note has been mostly under 3%—and as low as 0.5% just three years ago. Recently, the yield on the 10-year T-Note has flirted with 5% and today stands at 4.9%.

As most of the loans that consumers borrow—30-year mortgages, car loans—are based on the yield of the 10-year T Note, this sharp rise in the rate will have ripple effects across the economy, raising the borrowing costs of virtually everyone and everything (including the US Government). That, in turn, should prove something of a headwind for economic growth, though how strong is unclear.

More immediately, sharply rising Treasury rates generally have a depressing effect on stock prices, as they did in Q3. They do for the simple reason that as rates rise on super-safe US Treasury debt, the risky returns of stocks look incrementally less attractive.

When the T Note yield was at 0.5% back in 2020, if you wanted any real—that is, after-inflation—return on your investments, you didn't have much choice but to go into stocks. This became the meme TINA: There Is No Alternative [to stocks]. With bond rates near 5%, now there is.

RATES and P/E's

With attractive alternatives in the bond market, investors reduced the amount they'd pay for a dollar of a company's earnings. That is, the P/E for stocks declined. And when P/Es contract, the stocks with the highest P/Es take the biggest hit. Guess who those stocks were/are: Apple, Microsoft, *et al*. So, these first-half high flyers took it on the chin in Q3.

That said, it's a normal and, indeed, healthy process for a stock or a stock index to "consolidate" following large gains, that is, retrench a bit, digest the gains for a while, before resuming the uptrend. A pause that refreshes, as the saying goes. So far, the stock market's decline that began in Q3 looks like just such an orderly consolidation.

SOFT LANDING

While naysayers on the economy remain common on Wall Street, the actual data on the economy has been very encouraging. So far, the Fed's policy of raising interest rates to cool inflation has succeeded in substantially bringing down inflation—from roughly 9% 16 months ago to roughly 3.5% today (using the Fed's preferred inflation metric, the Personal Consumption Expenditure index or PCE). And yet at 3.8% the US unemployment rate still hovers near historic lows and job creation remains strong. This looks a lot like the so-called "soft landing" that few (mea culpa) thought likely: where the Fed succeeds in bringing down inflation without tipping the economy into recession.

Particularly encouraging is the data for the September just ended, which showed the US creating 336,000 net new jobs for the month, a very strong showing, while average wage growth slowed to an annual pace of 3.4%. Recall that the Fed believes that too-strong wage growth is the ultimate cause of inflation. So slowing wage growth sufficiently to cool inflation is a key goal of the Fed.

A back of the napkin calculation for how wage growth generates inflation is to take the current nominal wage growth rate = 3.4% and subtract current productivity growth = 1.5% and that gives you the resulting expected inflation rate = 1.9%. 2% is the target inflation rate the Fed has said its aiming for.

NO LANDING?

Recent economic data lends support to the notion that the Fed may well be near--or even at--the end of rate hikes. And that's good news for stocks. But, the surprising continuing strength in the US economy (where did that recession go?) has also reduced the odds that the Fed will ***cut*** rates multiple times in 2024 in order to stimulate the economy. The economy may not need stimulating as it may not slow = no landing.

If no Fed rate cuts appear on the horizon, interest rates may remain higher for longer than previously expected. And higher rates for longer means continued pressure on stock P/Es. This would definitely be a headwind for stocks, rather than the previously expected tailwind for stocks from lower interest rates following Fed rate cuts.

We can make arguments for rates easing or remaining high, but what does seem clear is that stocks' path in 2024 will likely be driven by the path of interest rates.

ISRAEL & HAMAS

The recent attack of Israel by Hamas is, of course, a shocking humanitarian tragedy and a potentially destabilizing force in the Middle East. Frankly, the possible outcomes are all over the map, both figuratively and literally. Given this range of possibilities, trying to frame the implications for investors is a fluid exercise—ranging from a contained war between Israel and Hamas with limited repercussions to a war between Israel and Iran, the backer of Hamas, with more far-reaching implications.

The primary market concern relates to potential disruptions in oil supplies, which could result from a broader conflict between Israel and Iran. For those who remember the 1973 Arab oil embargo that caused the price of oil to quadruple, current events can trigger painful memories.

But it's important to note that since 1973 the sources of oil have greatly diversified, with the US becoming the largest oil producer in the world. So, sanctions blocking Iran oil exports—equal to about 1% of global oil production—could cause an oil-price shock, if other producers didn't step in to make up the loss (which they might). That said, it would be nothing remotely on the scale of 1973 or of what happened to oil prices when Russia invaded Ukraine.

POST SCRIPT

As ever, the future is full of uncertainty. The political and geopolitical arenas here and abroad are full of worrisome portents. Under these conditions, it's best to keep in mind the old Wall Street saying that bull markets climb walls of worry. Why? Because when investors are worried, they hold back cash from the markets, and that reserve cash represents future buying power, that is, demand for stocks.

It is perhaps the financial markets' greatest virtue and greatest vice that their functional concern is solely with economic outcomes. The horrifying human suffering of war is not part of that calculation.

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