Weekly Commentary with Professor Jeremy J. Siegel

Dominating Factors Determining the Course

Monday, 7/15/2024

The assassination attempt against former President Trump gave a bump to his odds of becoming president, as they rose from 60% to 67% on Monday morning on Predictit.org. This gave a short run bump to stock prices, as the equity market favors Trump, while the bond market traded off, as higher tariffs and/or faster economic growth weighed on fixed income assets. However, other economic factors, particularly earnings, inflation, and economic growth, will be dominant in determining the course of stocks and bonds over the next four months.

Last week's Consumer Price Index (CPI) data provided significant relief for markets, as it showed a welcome slowdown in inflation. This is particularly important data as we consider a potential shift from growth to value stocks, which may not fully materialize until the Federal Reserve (Fed) begins adjusting interest rates downward.

While the CPI showed very encouraging signs, the Producer Price Index (PPI) came in above expectations. But the PPI does not typically forecast the Fed's preferred Personal Consumption Expenditure (PCE) data as accurately as the CPI. In totality, the inflation data last week underpins my view that we will see a rate cut in September.

The jobless claims report from the July 4th week, despite showing a decrease, might not be entirely reliable due to the holiday affecting unemployment office operations. We'll need to closely monitor next week's figures to confirm any real trends in employment changes. If jobless claims or other economic indicators show weakness, the conversation might shift towards more aggressive rate cuts, possibly even a 50-basis point reduction in September.

The Russell 2000 Index surged in response to the CPI report, and one of the largest divergences between small and large stocks on record. Small caps are extremely sensitive to interest rate expectations since they are more reliant on short-term financing. Easing financial conditions will disproportionately benefit smaller companies over larger tech firms, which have dominated the market rally in recent years.

As we begin earnings season, we'll be watching whether the productivity slowdown for the economy at large I talked about in last week's commentary is reflected in margins or corporate earnings. Earnings expectations for the S&P 500 over the coming 12 months have expanded 8% since the start of the year, while small caps (S&P 600) have seen earnings estimates remain unchanged. For a small cap rally to last, earnings growth in these stocks will have to pick up.

In summary, while there are mixed signals from the various economic data points, the overall trajectory suggests a market on the cusp of a shift of value stocks regaining prominence, driven by easing monetary policies and a broadening of market participation.

Glossary

Basis point: 1/100th of 1 percent.

Consumer Price Index (CPI): A measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. The CPI is calculated by taking price changes for each item in the predetermined basket of goods and averaging them; the goods are weighted according to their importance. Changes in CPI are used to assess price changes associated with the cost of living. Core CPI excludes food and energy costs.

Federal Reserve (Fed): The Federal Reserve System is the central banking system of the United States.

Personal Consumption Expenditure (PCE) Price Index: A measure of the prices that people living in the United States, or those buying on their behalf, pay for goods and services. The core PCE Price Index measures the prices paid by consumers for goods and services without the volatility caused by movements in food and energy prices to reveal underlying inflation trends.

Producer Price Index (PPI): A weighted index of prices measured at the wholesale, or producer level.

Russell 2000 Index: Measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.

S&P 500 Index: Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

S&P 600 Index: An index of small-cap stocks managed by Standard and Poor's. It tracks a broad range of small-sized companies that meet specific liquidity and stability requirements.