OBSERVATIONS: *S&P 500 posts best week in nearly one year, manufacturing still soft, services remain in expansion.*

- The S&P 500 rallied last week by +5.9%—the best weekly gain of 2023—and turned the fourth quarter-to-date performance positive by +1.75%. Small caps also gained during the week (more in One More Thought), posting +7.6% gains while 10-Year US Treasury yield fell -26bps to end the week at 4.57%.[1]
- The recent drawdown in equity markets, punctuated by October's weakness, has left the S&P 500 trading at a 17.5X price-to-earnings (forward 12 months) ratio. While still high in aggregate, when excluding the magnificent seven (Apple, Microsoft, Amazon, Alphabet, Meta, Tesla, and Nvidia) that ratio drops to 15.5X.[1]
- Core inflation in the Eurozone fell to +4.2% year-over-year (YoY) in October, down from +4.5% in the month prior and the lowest level since July 2022. The Eurozone economy contracted in Q3 (quarter-over-quarter) by -0.1% versus expectations for zero growth.[1]
- Productivity in the third quarter reached +4.7% YoY, well above expectations of +4.3% and similarly above Q2's reading of +3.6%. This marked the highest productivity rate since Q3 of 2020.[1]
- The manufacturing sector remained in contraction for the 12th consecutive month after registering an October reading of 46.7 (readings below 50.0 indicate economic contraction). This figure marks the lowest level since July 2023 and is below the twelve-month average of 47.4.[2]
- The ISM Services Index declined in October to 51.8 vs. expectations for 53.0 and September's 53.6 figure. This marks the 10th consecutive monthly reading above 50.0, indicating economic expansion.[1]
- Jobless claims continue to hover near 200k and remain below 2023's weekly average of 227k. The most recent week's 217k claims was a modest uptick from the previous week's revised 212k figure.[1]
- Jobs grew at a healthy pace in October as the US economy added 150k new jobs. However, this figure was below expectations for new jobs (consensus was for 180k), the unemployment rate ticked up to 3.9%, and job growth figures for both August and September were revised lower.[1]

EXPECTATIONS: *AI regulation coming, Fed pauses for second straight month, earnings season nearly complete.*

- The Biden administration unveiled an eight-part Executive Order (EO) on artificial intelligence. The EO is centered around notable points of consumer privacy and protection, promotion of innovation and competition, guidelines for federal agencies use, and establishing practices on the role of AI in the justice system—including use in sentencing, and crime forecasting.[3]
- Unsurprisingly, the Fed left interest rates unchanged—for the second consecutive meeting— at a target range of 5.25% to 5.50%. Policy makers continue to be in wait and see (data dependency) mode as higher for longer continues to make its way into the economy. For now, markets are pricing in less than a 10% chance for another rate hike at the last meeting for 2023 on December 12-13.[1]
- 81% of the S&P 500 companies have reported thus far, 82% of which have reported a positive earnings surprise—better than the 5-year (78%) and 10-year (74%) average for the percentage beating estimates.[1]

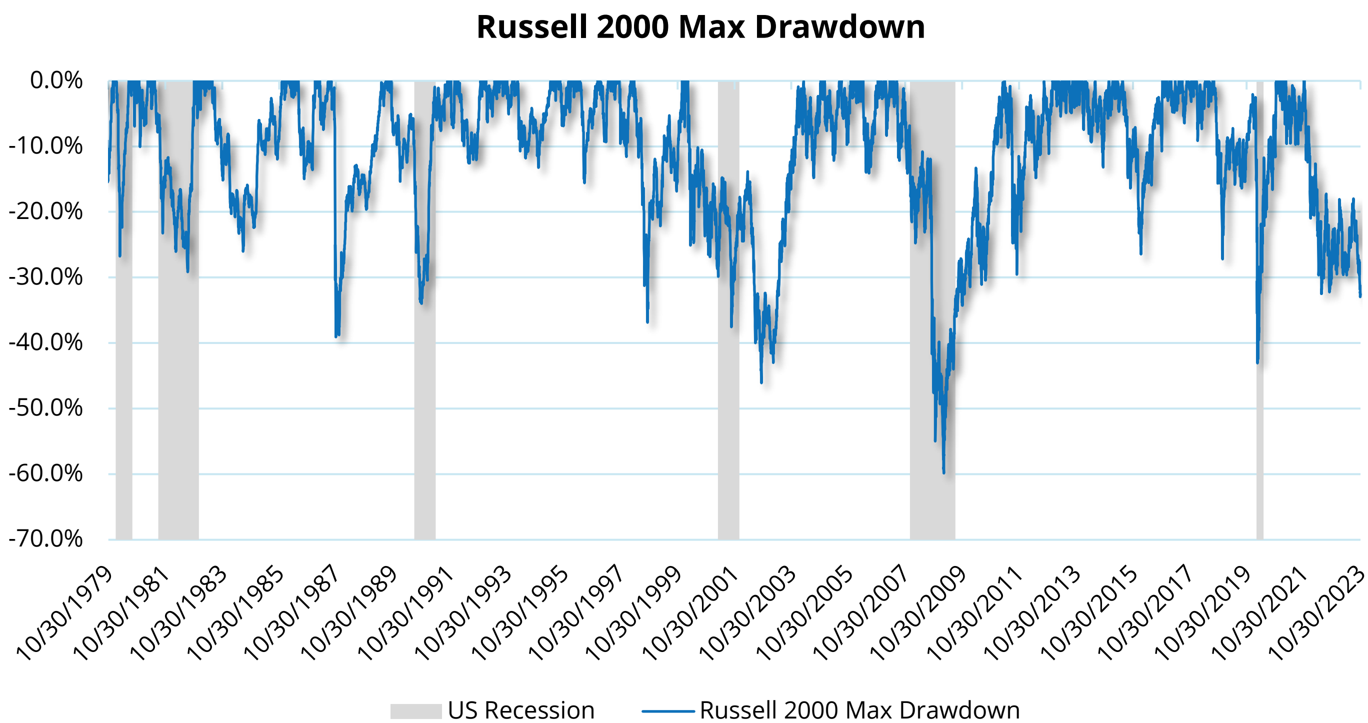
ONE MORE THOUGHT: *Small cap drawdown on par with some of the worst[1]*

US Small caps (Russell 2000 Index) have been beaten up of late. Since this year's peak in the Russell 2000 Index on 31-Jul-2023, small caps were down over -16% through the four months ending on 31-October—double the decline of the S&P 500 over the same period. Small caps surged in 2021 as the US economy re-opened after the Covid lockdowns of 2020 and the Russell 2000 Index hit an all-time high on 8-Nov-2021 but began to struggle as the Fed

[1] *Bloomberg LP*
[2] *https://www.ismworld.org/supply-management-news-and-reports/reports/ism-report-on-business/pmi/october/, as of 11/1/2023*
[3] *https://www.cnbc.com/2023/10/30/biden-unveils-us-governments-first-ever-ai-executive-order.html*

signaled it would be aggressively raising rates to combat inflation. By June-2022, US small caps had lost over -30% and were in a bear market. However, the decline of the last four months has caused US small caps to hit a new bear market low just two weeks ago on 27-October. This prolonged drawdown in small caps (see Chart of the Week) is not the worst in magnitude—2008 was worse—nor the longest—late 1990s small cap bear market was longer—but only in these two episodes has the Russell 2000 gone longer without setting a new 52-week high. At this point, 26% of the Russell 2000 Index is now trading below pandemic lows on a Price-to-Sales (forward, 12-months) basis and the total index is trading at 1x forward sales compared with 0.7x at the pandemic lows. As signals mount that the Fed hiking cycle may be over, the headwinds arrayed against the small cap sector should begin to subside. So long as the US economy stays out of a recession, the current valuations as well as their divergence from their large cap peers suggest better days ahead for US small cap stocks.

CHART OF THE WEEK



Source: Clearstead, Bloomberg LP, as of 10/30/2023

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