2024 Outlook

No Room for Mistakes

As we turn the page to begin a new year, it is a good time to reflect on the past 12 months and think about what to expect from the economy and markets heading into 2024. We continue to be affected by the cross currents stemming from stronger-than-expected economic growth and the potential for interest rates to fall in 2024. The pandemic is becoming a distant memory as it began four years ago, though the effects of policy decisions are still felt today and into the new year.

2023

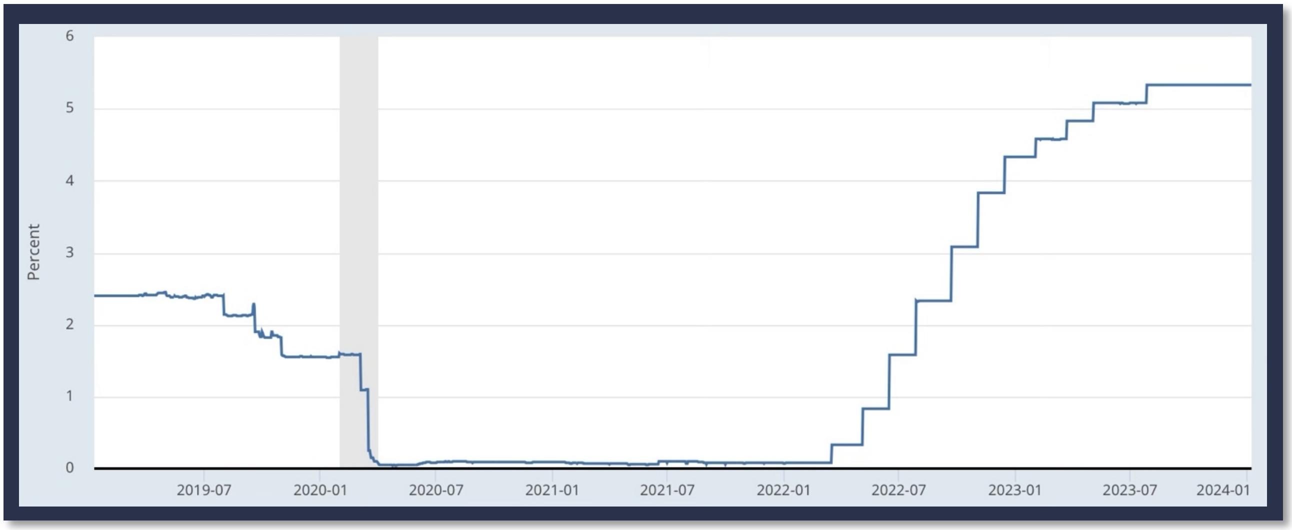
As last year began, most investors believed we'd see a recession. The Federal Reserve (Fed) had raised interest rates throughout 2022 to a level not seen in over a decade. Since higher interest rates usually mean an economic slowdown, it seemed likely this time wouldn't be different. However, the economy was growing at an above-average pace, and the inflation that the Fed was trying to fight was declining at a rapid pace. In addition, the labor market was strong with unemployment stubbornly below 4%. As a result, 2023 was a good year for economic growth.

A recession didn't transpire! In fact, the economy grew for the first three quarters of last year by 4.9%. And while the fourth quarter looks to have grown quite a bit slower, i.e. less than 2%, the year turned out better than expected.

During the end of 2023, stock prices shot higher, and interest rates fell. You could say that investors priced assets, leaving no room for mistakes. Does this mean that there is nothing to worry about? To the contrary, there are, so let's review.

2023

This chart shows the path for the Federal Funds rate over the last three years. This rate is what bond investors use to target the yield of Treasuries, corporate and municipal bonds. When it moves, the yields on these other bonds moves as well. Think of this rate as a gas pedal or break. When it is moving higher, it is meant to slow the economy and raise the cost of capital for businesses and borrowing for individuals.



Source: Board of Governors of the Federal Reserve System

As an example, from early 2022 to late 2023 the cost of a home mortgage went from near 3% to over 7%. Not surprisingly, this slowed the housing market, having the Fed's intended effect.

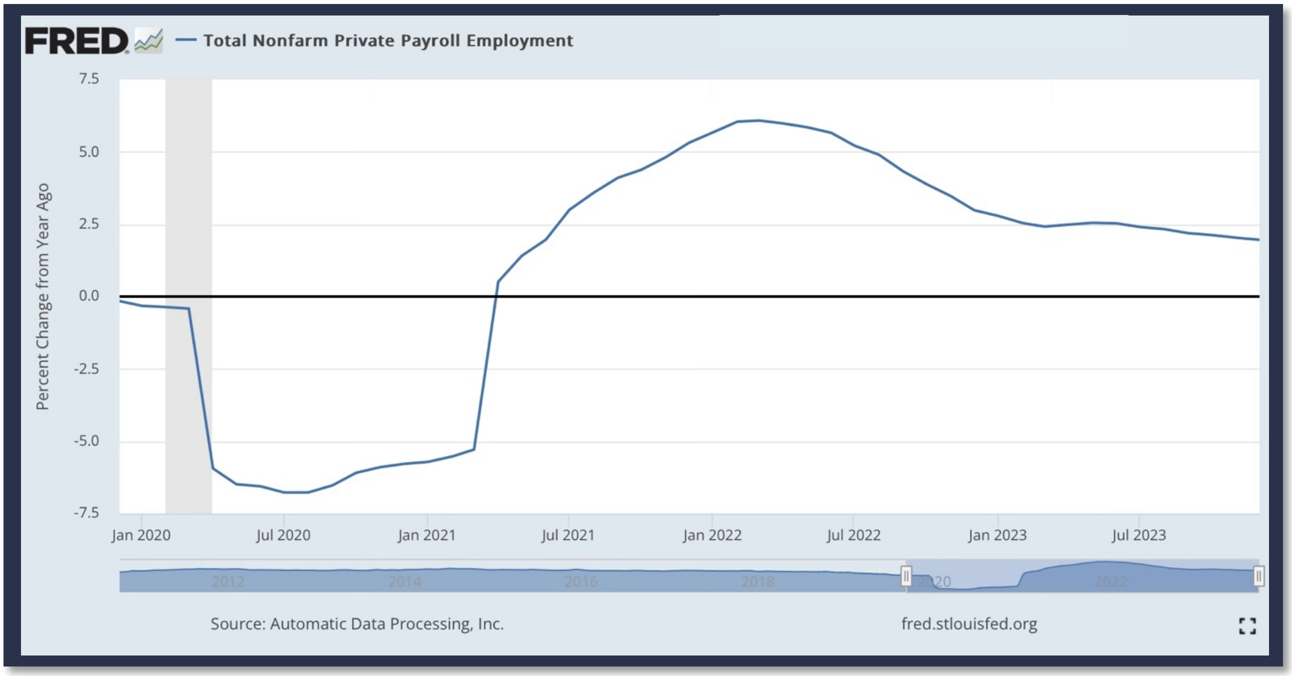
These higher interest rates have had the desired effect of reducing inflation. The core rate of inflation, that is the consumer price index (CPI) less the volatile components of food and energy dropped from a peak of 6.6% to 4.6% during 2023. When adding back those two components, inflation dropped from 9% at its peak to just 3%! We aren't sure

that the Fed should take all the credit, post-pandemic influences affected many areas of the economy as well.
Oil prices declined during 2023, benefitting from an increase in production that started in 2022. A new rig takes 6-12 months to produce. The drop in demand decimated oil prices during 2020 when the price of West Texas Intermediate crude oil was $40 per barrel. As the economy recovered, prices rose all the way to $120 per barrel. This caused an increase in some of the inflation in 2021 and 2022. At that price, everyone who owned a right or rig wanted to produce. As 2023 came to a close, the U.S. was producing almost 13 million barrels of oil per day, an all-time high. This production, despite the war in Ukraine and the Gaza Strip, caused prices to come down to nearly $70 per barrel and inflation to cool.

Higher interest rates raised the cost of borrowing for automobiles. However, the lack of pandemic-era sales left demand strong, and we saw a recovery back to nearly 16 million cars and light trucks sold annually by mid June of last year. Those higher interest rates began to bite later in the year. With the average cost of a new car at $48k and a 5-year loan now at 7%, the monthly payment has risen to $950 per month, up over 10%. During the pandemic, new car supply dwindled and used car prices shot higher. Now that's reversing, also reducing the level of inflation.

Finally, the job market began to wane in 2023. After a great post-pandemic recovery, job growth slowed and as a result, wage growth slowed. However, it remained above average as employers were interested in retaining the employees they had. As the year wore on, we began to see some cracks in the labor market with layoffs in a number of industries, particularly technology. While the employment recovery appeared robust much of it was in healthcare, government and hospitality (those worst hit segments during the pandemic) driving over 1/3 of the employment growth in 2023.

We are seeing a slowdown in job creation. If you look at this chart showing the pace of monthly jobs created by the U.S. economy, you can see the decline from the peak in January of 2022.



All of this led to a volatile year for stock prices. As 2023 began and concerns about a recession flourished, investors sought safety in those stocks that had most underperformed in 2022. That year, Information Technology, Consumer Discretionary, and Communication Services stocks were the three worst-performing sectors. Not surprisingly, in 2023, they were the best. In fact, after Technology had a -28% return in 2022, it returned almost 58% in 2023! This rally led to a very "narrow" market, meaning there were few stocks in the S&P 500 Index that drove its performance for much of the year. After three quarters, 7 stocks accounted for 75% of its performance! As investors priced stocks for the perfect soft landing in Q4 2023, the rest of the market began to participate, and overall, it rose 26%.

We're reminded of how difficult it is to time the market looking back over the last several years and noting last year's fortunes after the prior year's losses. Think about the volatility we've seen during the last five years with big stock market declines due to the pandemic and then the prospect of a recession. Despite that, the average return for 5 years is over 15%.

Source: New York University

The Year Ahead

As last year closed, interest rates fell with bond investors feeling like the Federal Reserve is not only done hiking rates, but likely to cut them quite a bit in 2024. Stock investors believe that the economic soft landing will happen. That's the perfect balance of reduced inflation and slowing economic growth, avoiding a recession. While this is one scenario possible, there are others to consider.

Recession

The economy could still see a recession. While not the kind of recession we saw during the Great Financial Crisis of 2008-2009, it appears that the slowing job market is a result of companies seeing reduced demand. Whether that decline is significant enough to see a two quarters decline in the economy remains to be seen.

Geopolitics

Geopolitical concerns remain an issue this year. The war in Ukraine is now two years old. While the energy market in Western Europe has found alternative supplies, including from the U.S., the potential for price disruption and the subsequent issues with economic growth there give us some concerns about the recovery. In addition, Russia has other customers for its energy supply, including China. Their purchase of those supplies will fund Russian aggression on the Crimea peninsula.

Now add to this the 100 day old war between Israel and Hamas. The inclusion of terrorist groups supported by Iran and the tenuous position of Turkey in the region suggest that this may not "blow over" as quickly as many had hoped. Should the Mideast region become embroiled, this could have an impact on the oil prices as it remains a global commodity despite U.S, production.

Most significantly, we have a Presidential election in the United States. While the election itself may add volatility to asset markets, the real issues will be potential policy changes. As we approach the conventions in late summer and early fall, the planks of the parties' platforms will become more apparent, and we'll get some sense for the impact a winner could have on fiscal policy. Things like taxes, trade tariffs and immigration control will be on the ballot this year in addition to social issues. Not only is the President's race important but the control of Congress is so narrowly owned today that a change in control could create alignment that could create more significant policy change. We'll have to keep abreast of those issues as they become clearer throughout the year.

Interest Rates

The market has already decided that the Federal Reserve will likely reduce interest rates by almost 1.5% in 2024. The Fed is not as sanguine about their future policy. The economic data will help us determine which is the more likely outcome. In order for rates to be cut as many times as markets believe, we would need to see a further reduction in the rate of inflation by almost a third. We would also need to see a reduction in economic growth, though not so much as to suggest a recession.

The real impact of higher interest rates takes about 18 to 24 months to be fully felt. Rates started to rise early in 2022 which means that even now businesses and the economy are still adjusting to higher rates. We've seen over-leveraged industries like crypto currency have failures, and early last year, we saw banks whose balance sheets were mismatched have problems with several failing. It is still possible that as companies have to wrestle with debt refinancing at now higher rates, we'll see some additional problems.

For bond investors however, the higher yields on bonds have made them attractive again. Staying in cash to long and watching those 5%+ money market yields deteriorate is not a good plan. Investors should be discussing bond investments with their advisors, talking about their average maturity, and maintaining higher than average credit quality as the difference in yield between Treasuries and other bonds remains narrower than average.

Stock Markets

As mentioned earlier, stocks in the U.S. did very well in 2023. This leaves them somewhat expensive relative to earnings. In addition, investors expect more than a 10% growth rate in earnings in 2024. Should this come to fruition, it is already priced in.

In 2023, stocks traded with bonds all year. When interest rates were rising, stock prices didn't appreciate, save for those tech stocks mentioned earlier. As interest rates began to fall during the fourth quarter, stocks across the globe generally began to perform much better. In fact, if you look at stock price movement, it is directly correlated to interest rates in 2023.

Now, in 2024, it appears as though we're past the point where there is a question about interest rates moving higher. As a result, stock prices will begin to focus again on earnings. Because they were soft for much of the market last year, it may be easier to attain that 10%+ earnings growth rate. However, as stated, that is already priced in. So, in order for stocks to do materially better, earnings will have to be much higher, or interest rates will have to move much lower. Both scenarios seem less likely today.

There were underperforming sectors though. Consumer staples (auto companies), Energy and Utilities performed poorly. The consumer appears to be stronger than thought suggesting that a possible recovery in staples stocks. With energy prices remaining steady and production higher, we could see a rebound.

Real estate also didn't perform as well as the broad market due to the higher cost of capital. With interest rates likely to have peaked for this cycle, there is opportunity there again, especially as the demand for multi-family and residential housing will continue to be driven by the demographic strength of Generation Z.

Europe does not have this next generation. As a result, their economic recovery may be slower. The inflation effect coming from the Russian/Ukraine war's influence on energy prices will likely cause interest rates to remain higher for longer. The global economy is expected to grow at a slow pace of just 3%. Because Western Europe relies on exports to the U.S. and Asia for much growth, this could hamper the recovery as well.

Alternatives

The realm of private markets, equity, and credit, as well as real assets like real estate and commodities along with infrastructure, may provide benefits for portfolios in 2024. Most of these segments provide an illiquidity premium that is still attractive. The price volatility of these assets may often be different from public markets.

2024 will prove to be an interesting year. Of course, if you're a professional investor, we can say that about every year! Politics and economics are interesting bedfellows, so this year will be especially so given the election cycle here in the U.S. and the polarity between parties.

The Federal Reserve's likely pivot on interest rates will also be watched closely to determine just how far they may go in reducing interest rates. And while a recession is less in the cards, we wouldn't rule it out altogether.

So, while stocks and bonds are priced for the perfect outcome, it is too soon to believe that it is the only scenario to materialize this year!

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