

Economic & Market Commentary

Economic pain is likely to return in 2024, but that doesn't mean stocks will struggle all year, especially if there is a continuation of the "rolling recessions" that have been characteristic of the recent economy.

In essence, several key segments of the economy, including housing, manufacturing, and many consumer-oriented areas, have experienced recession-level weakness, while other segments, such as services, have not been hit to the same degree.

Looking ahead to 2024, the best-case scenario for the economy is for those rolling recessions to morph into more durable rolling recoveries.

It's possible that recent cracks in formerly stable segments will lead to recession-level weaknesses, hopefully offset by potential stability and/or recovery in segments that already have taken their hits.

However, recession risk is still a distinct possibility via a formal declaration by the National Bureau of Economic Research, the official U.S. recession arbiter since the late 1970s.

Federal Reserve monetary policy remains a wild card for 2024, as it was in 2023, although Fed Chair Jerome Powell's comments after the December policy meeting suggested the rate-hiking cycle is over and now investors are looking toward when the Fed will begin to cut the federal funds rate.

The Federal Reserve unanimously kept the federal funds rate unchanged at its latest meeting.

While the decision to hold the fed funds rate steady was in line with expectations, the accompanying statement and projections point to a shift toward easing in 2024.

Additionally, Fed Chair Jerome Powell's comments in his press conference confirmed that most members of the committee believe that the hiking cycle is over, and they discussed the path to lower rates. Inflation being the key to the policy pivot.

Encouraged by declining inflation, the Federal Reserve's Open Market Committee (FOMC) signaled that more rate hikes are unlikely in this cycle and that there could be 75 basis points in rate cuts in 2024.

The statement that accompanied the Fed's decision indicated that "growth of economic activity has slowed since the third quarter" and "inflation has eased over the past year."

In the accompanying Summary of Economic Projections (SEP), the median estimate of Fed officials suggests three rate cuts of 25 basis points each in 2024, bringing the fed funds rate to 4.6% compared to an estimate of 5.1% as recently as last September.

The Fed's quarterly economic projections suggest declining inflation. *Source: Federal Reserve Board, as of 12/13/2023.*

The Fed appears on track to "normalizing" interest rates from a tightening stance to a more neutral stance.

At neutral, the Fed hopes to have rates at a level consistent with slowing growth and inflation at 2%. Progress appears to be encouraging the Fed to begin rate cuts sooner rather than later. *Source: Bloomberg, monthly data as of 10/31/2023.*

The prospect of lower short-term interest rates is positive for the economic outlook and financial markets. However, the Fed does plan to continue to reduce the size of its balance sheet by allowing bonds it holds to mature without reinvesting the principal.

Along the lines of the warning, "be careful what you wish for," it may be that if the Fed is cutting rates by mid-2024, it's because of further deterioration in the economy, specifically the labor market.

The Fed operates under a dual mandate to promote both stable prices and maximum sustainable employment.

One of our key expectations for 2024 is that the Fed will begin to shift its focus from the inflation side to the employment side of that dual mandate.

The unemployment rate has started to move higher, now approaching 4%, having bottomed out at 3.4% in early 2023.

Keep in mind that a high unemployment rate doesn't bring on a recession, it's recession that ultimately causes the unemployment rate to jump.

The leading market theme in 2023, and likely heading into 2024, has been the dominance of the "Magnificent 7" group of mega-cap stocks: Alphabet, Amazon, Apple, Meta, Microsoft, NVIDIA, and Tesla.

These giants pushed market-cap-weighted indexes like the S&P 500® higher during 2023, but keep in mind that that they also contributed to the bear market plunge in 2022.

This highlights an important aspect of the mega-cap highfliers worth noting for the future. They are not immune to the business cycle and can also be a drag on cap-weighted indexes.

That, in turn, emphasizes the importance of diversification when it comes to the mega caps and the rest of the market.

It might sound odd when they're leading the charge, but it comes in handy when they're falling behind.

There will be a shift towards artificial intelligence (AI). AI has both captured investors' hearts and minds and contributed to the outperformance of both the Magnificent 7 and technology stocks more broadly.

It is believed that in 2024 there will be less about the creators of AI versus the adopters across the spectrum of industries and sectors as companies increasingly focus their capital spending on productivity-enhancing investments.

Key to the shape of the market landscape in 2024 is how the economy reacts to the lagged effects of tighter monetary policy and accepting a long-term shift away from low interest rates.

There will be a focus in 2024 for quality companies with strong free cash flow, lots of cash on the balance sheet, high interest coverage, and healthy real revenue growth, as debt servicing costs will likely grow in importance.

The case for lower interest rates in 2024 is straightforward, but the path is likely to be rocky.

Bond yields are expected to decline in line with falling inflation and slower economic growth, but uncertainty about the Fed's policy moves will likely be a source of volatility.

In 2023, 10-year Treasury yields have covered a huge range, from as low as 3.25% in April, in the wake of the banking crisis, to as high as 5.02% in October, on surprisingly strong third-quarter economic growth.

In simple terms, Treasury yields, which move inversely to prices, tend to rise when the economy appears to be strengthening and tend to fall when economic growth appears to be slowing.

Short and long-term yields likely have peaked for the cycle and will continue to fall assuming inflation declines in 2024.

It appears that much of the inflation driven by supply shortages early in this cycle has been corrected, but the full impact of the tightening in monetary policy by major central banks is still working its way through the global economy. Slower growth and less inflation pressure should be the result.

There will be lower yields and price volatility along the way, as markets continue to try to anticipate shifts in Fed policy.

In 2024, global markets are likely to begin a shallow U-shaped recovery rather than the V-shape seen in the last two global recessions of 2008-09 and 2020.

Global economic and earnings growth may be sluggish for much of next year which would mean that stock prices are more determined by valuations than earnings.

International stock valuations are already braced for an interesting 2024, with investor sentiment surveys in Europe not far from decade lows and the price-to-earnings ratio for the (Morgan Stanley Capital International and Europe, Australasia, and Far East Index) MSCI EAFE 15% below its 10-year average.

As the global economy transitions to a new cycle, markets are experiencing new leadership.

In 2023, the average international stock outpaced the average U.S. stock through late November.

The MSCI EAFE Equal Weight Index (where each stock in the index gets an equal weighting, as opposed to a market-capitalization-weight index), has outperformed the S&P 500 Equal Weight Index by nearly 5% in 2023, adding to the

15% of outperformance since the bear market ended in October 2022.

The reason many investors haven't noticed the outperformance of international stocks is that the seven mega-cap stocks (the Magnificent 7 mentioned above), which make up about 30% of the cap-weighted S&P 500, have prevented the S&P 500 index from underperformance in 2023. *Source: Schwab Center for Financial Research. Commentary as of 12/31/2023.*