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Marketing material

2024 Outlook: Long live this faint cycle or bumps toward a new one?

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IN A NUTSHELL

— An answer year: A soft landing, U.S. elections, more geopolitical rift or repair?
— Investment themes and views for 2024

An answer year: A soft landing, U.S. elections, more geopolitical rift or repair?

2024 should provide answers to many key investor debates; whether a soft or hard landing follows the U.S. Federal Reserve's (Fed) many hikes to fight inflation, determining a short or longer lasting expansion post COVID. This will shape monetary policy and normal interest rates. Yet, fiscal policy remains on an unsustainable path. U.S. elections can set new paths, influenced by the candidates and conditions. Beyond elections during a pivotal cyclical year, peace is still not yet found and U.S. and China tensions remain high as each tightens its circle of friends. If two cliques form, we'll judge the situation by the friends each keeps and the new friends each attracts. Beyond the macro, we watch powerful micro and thematic forces such as Artificial Intelligence (AI), which stole the show in 2023 and might again for the decade, but probably not in 2024.

Investment themes and views for 2024:

1. **Small U.S. recession first half (1H24), sub 1% 2024 gross domestic product (GDP) in U.S. & Europe, but corporate profits climb:** We expect a small recession in 1H24 led by continued weakness in durable goods demand and manufacturing, slow service consumption as jobs growth stalls along with a brief dip in investment spending as companies look to protect margins by curbing hiring, inventories and capital expenditure (capex) until more macro and cost of capital clarity emerges later in 2024. Despite brief GDP contraction, we expect very limited jobs losses owing to resilience in service consumption and tightness in labor supply from demographics. We expect disinflation, not deflation, benign credit costs and higher profits.

2. **2024E S&P earnings per share (EPS) $242 up 8.5%:** S&P EPS outlook assumes $80/barrel avg. oil, stable dollar, benign credit costs at banks with a Fed Funds rate cut in June and at 4.5-4.75% at 2024 end. Our profit outlook differs greatly by sector, we expect flat Financial, Energy and Auto profits, but up about 20% at mega-cap Tech firms, such as the Great Eight, with healthy 7-8% EPS growth elsewhere.

3. **4700 S&P 500 target for 2024 end with a sustained near 20 trailing price-to-earnings (P/E) ratio:** Our S&P target is 19.5x our 2024E EPS, supported by Treasury yields still below average since 1960, the S&P being more growth and Tech stock tilted and lower investment fees than history. Our real cost of equity (CoE) estimate is 5.75% = 1.75% 10yr Treasury Inflation-Protected Securities (TIPS) yield + 4% Equity Risk Premium (ERP). This supports a fair steady-state PE of 1/5.75% = 17.5. We then add a 10% premium for economic profit growth potential.

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4. **When will the Fed cut?** Unless the recession is sooner/deeper than we expect, we think rate cuts are unlikely until June 2024 to help smother the risk of inflation reaccelerating. While we think the Fed would like to validate a soft landing with a few cuts in 2024 (like 1995), opening the door to victory over inflation cuts before the November election likely requires unemployment over 4%, a few months of sub 100K new jobs and a stock market not near all time highs. Rate cuts continuing every other meeting in 2025, as we forecast, likely requires some fiscal tightening in our view.

5. **Long-term interest rates rise to pre financial crisis range. What's the norm for the 2020s?:** We expect 10yr Treasury yields of 4.2% at the end of 2024 with long-term inflation expectations and breakevens at about 2.5%. We estimate 10yr TIPS yields of about 1.75% at 2024 yearend, down from about 2% today; a bit higher than our 1.5% 10yr TIPS yield estimate going into 2023. 10yr yields overshot our expectation to touch 5% in October 2023, but since retreated to 4.2%. The bond market expects a weak 2024 economy and further disinflation. But the basics of reasonable long-term inflation assumptions and inflation/duration risk premiums remain unsure. Moreover, the deficit remains high and we believe the Fed will likely sell over $1 trillion of Treasuries and mortgage-backed securities (MBS) next year.

6. **How to tame inflation in 2020s? Fiscal discipline and more productivity are key:** Keeping inflation tame will be challenged by conflicts, reshoring, demographics, environmental and other regulations, also the stable but slower inertia of mature service oriented economies. This should affect real growth more than inflation if there is monetary and fiscal policy discipline; but discipline can be tough politically, so it's important to guard against inflation risks. Productivity is key to good growth and alleviating difficult policy choices. Artificial intelligence (AI) is exciting, but meaningfully boosting productivity and growth takes time. Healthcare is the biggest and fastest growing part of the U.S. economy, consumption and jobs; innovation here is crucial for productivity and growth.

7. **S&P sector strategy:** With disinflation and a weak macro backdrop seen ahead, we embrace less cyclical and intermediate duration assets, including investment grade credit. In equities, we seek bond substitutes (Utilities, Infrastructure) and secular trends resistant to cyclical disruptions, such as Healthcare in an aging world, productivity enhancers in a tight labor market (Tech Services, Capital Goods). We're cautious on Consumer Goods and now also many Services, but we see further rebound for advertising and airlines. We cut Financials to neutral, with a smaller overweight on big Banks and Insurance and now a small overweight on Energy. We remain overweight Health Care, Communications, Industrials and most underweight Tech and Consumer Discretionary, particularly Semiconductors and Auto. Beyond cyclical risks, car wars will continue and chip wars are likely next. We expect companies and governments to compete aggressively to ensure a place in electric vehicle and chip making and don't expect shareholder returns to be prioritized.

8. **A better relative decade likely for small vs. large caps:** We believe competitive U.S. corporate tax rates, strong/stable dollar, normal interest rates and reshoring suggests better small vs. large cap performance.

9. **Keep foreign equities in the portfolio, search for value and lower correlations:** The 5 largest companies are 25% of the S&P 500, thus we value diversification. Europe and Japan are value tilted with less Tech. We keep modest exposure to China's Tech firms which we think are heavily discounted for government risk.

10. **2024 chutes & ladders:** Negatives: Recession or <5% S&P EPS growth, destabilizing U.S. election results. Positives: S&P EPS growth >10%, 10yr Treasury yield <4% and no recession.

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Glossary

Artificial intelligence is the theory and development of computer systems able to perform tasks normally requiring human intelligence

Breakeven rates provide a useful measure of average inflation expectations derived from inflation linked sovereign bonds

A budget deficit is created whenever the spending in a public budget exceeds the income within a given time period

Capital expenditure (Capex) are funds used by a company to acquire or upgrade physical assets such as property, industrial buildings or equipment.

In business administration, the cost of capital is the cost incurred by a company in using equity capital for investments or in obtaining debt capital for them.

Cost of equity (CoE) is the return (often expressed as a rate of return) a firm theoretically pays to its equity investors, to compensate for the risk they undertake by investing their capital.

describes a slowing of the pace of price inflation.

Durable goods are long-lasting and do not have to be purchased frequently.

Earnings per share (EPS) is calculated as a company's net income minus dividends of preferred stock, all divided by the total number of shares outstanding.

Equity risk premium is an excess return earned by an investor when they invest in the stock market over a risk-free rate. This return compensates investors for taking on the higher risk of equity investing.

The term federal funds rate refers to the target interest rate range set by the Federal Open Market Committee (FOMC). This target is the rate at which commercial banks borrow and lend their excess reserves to each other overnight.

Fiscal policy describes government spending policies that influence macroeconomic conditions. Through fiscal policy, the government attempts to improve unemployment rates, control inflation, stabilize business cycles and influence interest rates in an effort to control the economy.

Geopolitical risk is a risk that an investment's returns could suffer as a result of political changes or instability in a country.

The gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

Monetary policy focuses on controlling the supply of money with the ulterior motive of price stability, reducing unemployment, boosting growth, etc. (depending on the central bank's mandate).

A mortgage-backed security (MBS) is a special type of asset-backed security where the holder receives interest and redemption payments from pooled mortgage debtors, secured by the underlying mortgages.

The price-to-earnings (P/E) ratio compares a company's current share price to its earnings per share.

Productivity measures how much economic output is produced for a given level of inputs (such as capital and labor).

A recession is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

A soft landing is when an economy's rate of growth slows in a controlled fashion without major disruptive effects on employment, external balances etc.

Small cap firms generally have a market capitalization of less than $2 billion.

The S&P 500 is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

Treasury Inflation-Protected Securities (TIPS) are a form of U.S. Treasury bonds designed to protect investors against inflation. These bonds are indexed to inflation and pay investors a fixed interest rate as the bond's par value adjusts with the inflation rate.

The U.S. Federal Reserve, often referred to as "the Fed," is the central bank of the United States.

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