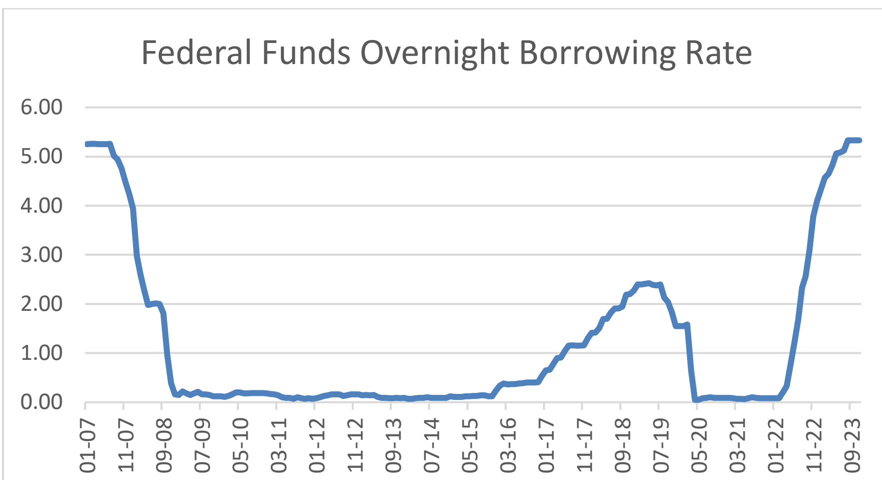
Economic and Market Outlook 2024

"Slower Growth, No Recession"

- U.S. economic growth is set to slow next year as higher interest rates finally begin to bite into economic activity. That said, I'm not anticipating a recession. Instead, the path to lower inflation engineered by the Fed via monetary tightening is likely to play out as a "soft" rather than "hard landing", with slow but positive 2%-ish GDP growth in 2024. Not great, but well above "stall speed".

- The Fed's rate hiking campaign of 2022 / 2023 is now likely finished. That campaign came very close to being "to much, too fast". But the potential for a mini-banking crisis early in 2023 both caused the Fed to slow down *and* at the same time illustrated the resiliency of the post-GFC fortified banking system. One reason that we don't expect a recession to ensue is indeed because no financial crisis has erupted out of the Fed's tightening campaign and because of the availability of credit outside of the banking system is more robust than in past cycles. Another reason is that both households and businesses have benefitted from having previously locked-in low fixed-rate borrowing costs when rates were lower.



Source: Federal Reserve Board

- While the Fed is likely done raising rates, we expect the committee to continue to reduce the size of the Fed's $7.8 trillion balance sheet at a pace of roughly $1 trillion per year. This process offers the Fed a "tightening offset" should they wish to cut short-term rates in response to slowing economic growth.

- Whether inflation recedes further and enough for the Fed to *actually cut rates* is another matter. It now seems likely that inflation will continue to moderate and that the Fed will be able to cut rates by the early summer. In this case, there would be a minor cross-purpose conundrum introduced for a period of time via rate easing being run concurrent with balance sheet tightening. I don't expect extreme rate cuts, next year, however. Perhaps 100 basis points (1.0%) of cuts may be in the cards over the course of the year.

- Equilibrium neutral interest rates (those expected to prevail most of the time) have likely risen this cycle to a new higher plateau (perhaps 4.0% mortgage rates are no longer likely, but 5.5% or 6.0% may now be). The two key reasons for this seem to be 1) a shift towards de-globalization (i.e. onshoring and friendshoring) which will, at the margin, curb the benefits of open trade and comparative advantage and 2) persistently high sovereign debt levels (including especially the U.S.), exerting downward pressure the equilibrium clearing price for treasuries and other government debt.

- Offsetting these gloomier developments is AI (artificial intelligence), which is set to boost productivity in the decades ahead. We're already seeing a slight pickup in U.S. productivity, but the biggest impacts are still perhaps 5-10 years away. The good news is that AI, like predecessor game changing technologies, is unlikely to lead to either a surge in unemployment *or* pose an existential risk to the human race, despite some of the current fearmongering.

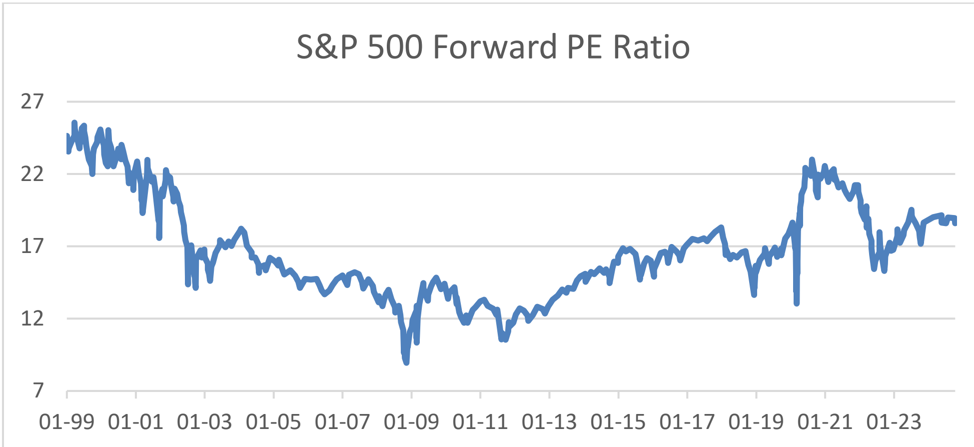
- Whichever party wins the Presidential Election in November, it seems likely that excessive Fiscal Spending is a thing of the past. We can already see that it is getting harder and harder to pass spending bills; and the summertime government shutdown-showdown and Treasury issuance tantrums have certainly scared elected officials and policymakers including treasury secretary Janet Yellen.

- Beyond the election, geopolitics and conflicts will continue to exert forces on markets. For now, conflicts seem contained, but any regional escalation could significantly impact markets.

Stocks and Bonds

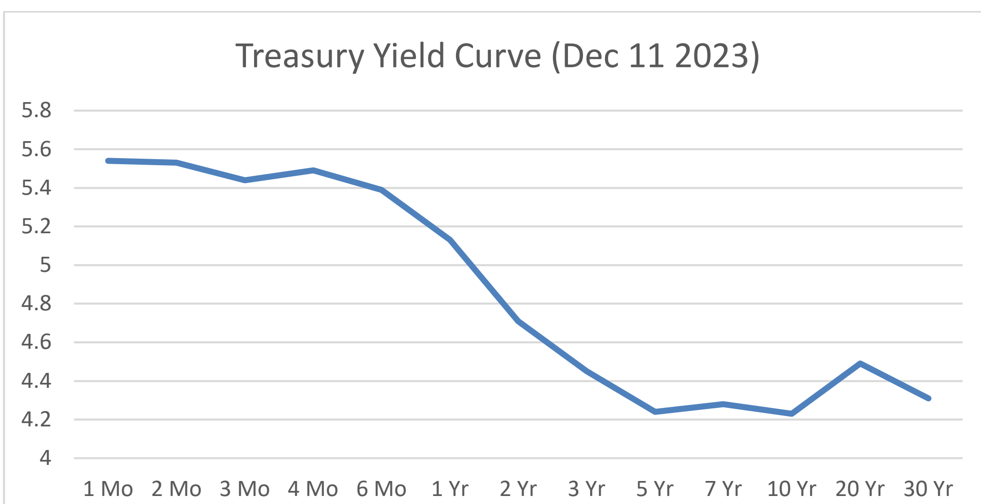
- The S&P 500 is expected to end 2024 not too far off from current levels. J.P. Morgan's strategist is the most bearish amongst the big banks, expecting a 7% or 8% decline in that index. Morgan Stanley, UBS, and Wells Fargo are expecting a flat market by the end of the year. Goldman Sachs, Soc Gen, and Barclays are calling for positive 5% returns for the index. More bullish are Capital Economics (that one surprised me), Fundstrat (that one did not), BMO and Deutsche Bank, with the latter group calling for more normal 8% or 10% gains in 2024 (source: Financial Samurai).
- We think an outcome in the range of -10% to +10% for the S&P 500 seems plausible given relatively high valuations offset by slowing inflationary pressures, a non-recessionary economic backdrop, and modestly higher earnings estimates.
- Given this outlook against a backdrop of 5% bond yields, most U.S. investors can afford to be slightly underweight equities relative to short-duration high-quality fixed-income.
- Beyond the blue chips, small cap stocks have a better than even chance of besting the mega-caps in our opinion. Valuations are significantly lower, and small-caps stand to benefit should lower rates continue to come into play. While the forward P/E Ratio for

the large-cap weighted S&P 500 is currently at about 19 times, the corresponding ratio for mid-and-small-cap stocks are both at about 14 times.



Source: Yardeni Research via I/B/E/S data by Refinitiv and Standard & Poor's

- As there was probably a fair amount of tax-loss selling in 2023, investors may want to gear up for a 1st quarter rotation whereby the laggards of 2023 temporarily outperform and the leaders of 2023 lag for a spell. This would argue for an early-in-the year rotation out of mid and high growth companies and into either value stocks or at the least GARPY stocks.
- After getting beaten-up over the past three years, bonds are likely to fare better over the next few years as higher current yields offset price risk. A reasonable range for 10-year notes for 2024 would be 3.5% to 4.0% on the low-end (if a quasi-recessionary environment were to play out) and 5.0% to 5.5% on the high-end (for example, in a "boomier" economic environment). As for the curve, I am expecting more steepening of the 2-year / 10-year yield curve spread, which has already steepened by about 50 basis points since the summer.



Source: Federal Reserve Board

Financial Product Trends

- Private credit (i.e. nonbank lending) has seen huge growth over the past few years due to a combination of chartered banks pulling back from certain types of riskier lending as well as investor interest in less price volatile "fixed income" vehicles. Accordingly, a number of access vehicles have made their way to market for both accredited and non-accredited investors, with many available as "interval funds". These funds invest either directly in (mostly secured) loans to companies and individuals or invest in specialty funds that do so (the latter structure is referred to as a fund of funds). We have invested in private credit as well as private equity for a few clients.
- Actively managed ETFs (exchange traded funds) are bringing the benefits of ETFs to investors interested in active management without some of the headaches of traditional mutual funds. Traditionally, ETFs were "passive" - that is they strictly followed a financial index like the Nasdaq 100 or the Russell 2000. More recently, active ETFs in both fixed-income and equities have begun to be issued by high-quality asset managers. In these cases, managers are running some of their flagship strategies (slightly modified) in ETF format, providing investors with in many cases a lower-cost, easier to trade, and more tax-efficient version.