Weekly Market Flash

Our 2024 Outlook

January 12, 2024

As we normally do this time of the year, we are sharing with you our outlook for the economy and markets in 2024. For our clients, you will see this week's commentary again as the executive summary of the Year Ahead report you will receive from us in a couple weeks or so from now.

The Economy: Slower, But Still Growing

The biggest economic story of 2023 was about something that didn't happen. There was no recession in the United States or, for that matter, in the global economy at large. Against the predictions of most mainstream economists (ourselves included), the American consumer put the pedal to the metal and spent, spent, spent. The jobs kept coming, month after month. Gross Domestic Product rose in the third quarter by an annualized rate of 4.9 percent, a pace way above historical trends. All this happened while interest rates kept going up and consumer prices kept going down. In the early days of 2024, it looks increasingly likely that the Fed's monetary tightening program, begun nearly two years ago, will result in the often hoped-for but seldom achieved "soft landing."

The economy's better than expected situation could prove to be a tailwind for risk assets this year; however, there are plenty of potential challenges that could trip up performance as well. Businesses will have to deal with the twin obstacles of a likely slowing pace of demand, and of a loss of pricing power as inflation continues to recede. There is also the chance that China's ongoing economic troubles reach a critical point this year. Finally, the geopolitical landscape looks to be anything but ordinary. More than two billion people in more than seventy countries are likely to cast ballots in nationwide elections this year, the most ever. Some of these will be highly consequential, and arguably none more so than our own presidential contest this November. Meanwhile, destructive wars rage on in Ukraine and the Middle East, and Taiwan is never far from the mix when the question of the next major flashpoint comes up. In short, there are reasons to be optimistic this year, and there are also reasons to be cautious.

Here is how we see the year progressing (as always, please remember that these views are subject to change, based on imperfect and incomplete information, and may not correspond to actual outcomes). The economy will continue to grow, although at a slower rate than in 2023. In our opinion the two big macroeconomic stories of the year will be (a) the ongoing strength in the labor market, with the unemployment rate not likely to rise much above four percent; and (b) a continued decrease in consumer prices with the core Consumer Price Index falling below three percent by the end of the year. If this happens, it will constitute a textbook soft landing.

A soft landing, though preferable to a recession, is still what it says: soft, as in, not a period of robust growth. That will make for challenging conditions for businesses. A combination of softer demand and lower inflation will make it more difficult for businesses to achieve strong top line sales growth. With limited room for top line upside, these enterprises will need to find ways to achieve operating efficiencies to shore up their profit margins.

This spotlight on ways to improve profitability in the absence of strong sales will center around that other big story of 2023: artificial intelligence. Last year we witnessed an abject fascination by investors with the emergence of generative AI, popularized by accessible platforms like ChatGPT. This year, we expect the

market will be a bit more discriminating about the hype, and more interested in the practical question of what generative AI can do for businesses as they attempt to grow profits in a slowing economy. This brings us to an analysis of what the equity market may have in store for us this year.

Equities: Proof Of Concept For AI

Equities in 2023 largely boiled down to seven words: Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia and Tesla. These were the “Magnificent Seven” – the mega-cap tech stocks that for much of the year accounted for the entirety of the S&P 500’s price appreciation. The common thread between all these companies was artificial intelligence. Early last year, AI burst into the public imagination in a way that it had not previously, largely due to the arrival of generative AI platforms like ChatGPT and Dall-E with their user-friendly applications for the eerily prescient generation of textual and visual content. Investors quickly latched onto the Magnificent Seven as they all had features of GenAI at the core of their value propositions, with Microsoft and Nvidia perhaps the most prominent beneficiaries due to the former’s early embrace of GenAI progenitor OpenAI (not a publicly tradable company) and the latter’s dominant position as the supplier of the graphic processing units that enable GenAI applications to run.

We expect 2024 will be a different environment for AI, one less about hype and more about proof of concept. Beyond the novelty of AI-generated college essays or Impressionist paintings, the focus will shift to what businesses can do with GenAI to improve efficiencies and shore up profits. This is likely to be a particularly important issue this year as companies face a macro environment of cooling demand; operating efficiencies could potentially offset slower top line sales growth. But first, these businesses will have to show conclusively that these potential efficiencies exist.

Outside of large cap US equities, we do not see a compelling set of reasons to aggressively extend positioning. Our reasons for staying underweight in US small caps, non-US developed and emerging markets are structural, and nothing of recent note has changed our thinking.

Fixed Income: Less Drama, Please

If it took seven words to describe equity markets in 2023 (see above), it took just one word to encapsulate the bond market: Drama! Normally the most boring place in a diversified portfolio, offering safety and perhaps a predictable stream of income, the bond market was all over the place last year. The yield on the 10-year Treasury note, which plays a critically important role in investment markets as the “risk-free rate,” went up and down by greater magnitudes of percentage change than equities throughout much of the year. What made the bond market’s gyrations particularly puzzling was that the Fed was giving crystal-clear guidance throughout the year about its intentions with regard to interest rates. “Higher for longer” was the message reprised over and over again. In March, when an abrupt spate of insolvencies at several prominent banking institutions briefly raised fears of a full-scale banking crisis, the Fed continued to insist that it wasn’t done with raising rates. Yet the bond market immediately priced in a spate of rate cuts that were never going to happen. The same thing happened on two or three other occasions – traders furiously bought bonds and drove yields lower, the Fed came out and said “higher for longer” and yields spiked back up.

The central bank appears to be at the end of its monetary tightening program, and that could portend a somewhat calmer year ahead in fixed income. The short end of the yield curve in particular should not contain too many surprises. The Fed may cut rates a couple times, but then again it may not, depending on whether the economy is running hotter or colder than what is now the mainstream view of a middle-of-the-road soft landing. In the middle of the yield curve, assuming we manage to avoid a recession, the

persistent inversion between 2-year and 10-year maturities should revert to a normal upward-sloping curve at some point, but how and when that happens is still very much up in the air. We think a wide range of yields from around three percent to five percent is appropriate for maturities within the 2-10 year band, and that should give investors a chance to lock in positive purchasing power, potentially for a number of years to come.

Concluding Thoughts

We always tell our clients that we are not in possession of a crystal ball any more than anyone else is. We do foresee a great deal of uncertainty around elections, particularly as our nation's attention starts to fixate on the upcoming election during the primaries this spring and when the parties hold their conventions this summer. Markets may experience short-term fluctuations up or down during this period and in the immediate aftermath of November 5, but we believe it would be foolish for one to think that the timing, magnitude or direction of any such move could be capitalized on for tactical portfolio gains.

As has been the case in recent years, our asset allocation weights in 2024 will be divided between fixed income and equity asset classes for the most part representing liquid, relatively high-quality names (governments, agencies and investment grade corporates on the fixed income side, US large cap stocks for equity allocations). We do not see a compelling reason to venture into more exotic terrain as the year unfolds. Our approach to delivering long-term value for our clients is based on equities for growth, fixed income for safety, and keeping security selection decisions as simple as possible within the context of prudent diversification (Occam's Razor – don't make things any more complex than necessary to arrive at an informed conclusion). Our 2024 allocations will reflect an outlook based on a moderately positive environment for equities and more stable conditions for bonds than was the case in the past two years, implying incremental repositioning of fixed income away from short-term floating rate to intermediate fixed-coupon issues. As for all the things out there known and unknown that could trip up our assumptions, we believe we will be in a better position to countenance them if we refrain from making aggressive bets too far in one direction or another. We have little doubt that there will be surprises in store.

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