December 4, 2023 – 2024 Outlook

Good morning. It is the time of the year when various investment firms start to put out their 2024 Predictions, hoping the roll of the dice lands remotely in their favor. As is normally the case with our group, we simply try and look at what the data is telling us to help us have the best odds of a consistent and somewhat predictable outcome. To us, managing risk is the main objective. If you do that, you can control the volatility of your portfolio which helps to keep returns within an acceptable range.

When we started 2023, we said that the outcome for the markets would be very data dependent and that was largely the case. The most talked about and predicted recession in memory never came to fruition. The economy grew, although modestly, along with earnings. Interest rates were very volatile but more or less stayed within an expected range with the exception of the fall when the 10-year Treasury briefly topped 5% but never closed above that level. As of this writing, on December 4, 2023, the markets have enjoyed a great rally for the month of November and it looks like the major averages will have a respectable return in 2023 despite weathering some crazy events in the banking and commercial real estate sectors. For the S&P 500, the returns have been as concentrated as I've ever seen them, with 7 stocks accounting for the vast majority of the returns. Just look at the S&P 500 (+18.52%) vs. the "Cap Weighted" S&P 500 (+6.27%) where every company is given an equal weighting. In a normal market, the two averages are close together. When there is a dispersion from the mean, as there is this year, it means that either one must come up or the other has to come down to revert to the back to the mean. That will be a big question as we head into the new year: Can the rest of the market, the so-called S&P 493, catch up with Magnificent 7? Much of that depends on where we head from here.

To look in to 2024, we are going to weigh 3 scenarios: 1) Bull Case 2) Bear Case 3) Our Base Case.

Bull Case:

- Everything that the market has priced in so far in 2023 actually happens and things get better on the economic front.
- **No Economic Slowdown** – Growth stays positive and the consumer chugs along with Consumer Spending powering the economy forward in 2024. Unemployment remains steady.
- **Inflation Continues to Decline** – The Immaculate Disinflation continues as CPI (Consumer Price Index) makes its way towards the Fed's goal of 2%. Mild growth

and fixes to the Supply Chain will lead companies to cut prices to keep market share keeping a lid on price increases.

- **The Fed** – No Hawkish surprises. Even if rates don't decline, the most important thing is that they stop going up. Remember, if the Fed starts cutting rates aggressively, that usually means the economy is in trouble and earning will decline which will not be good for the stock market. We need stable rates that drift down slowly for a best-case scenario.
- **No Reduction in Earnings** – Growth needs to be good enough for companies to keep steady earnings growth. Technology will continue to let companies increase productivity and reduce costs. S&P 500 earnings remain at $245/share. Net takeaway the S&P 500 trades at 19x earnings which puts it at around 4700. Net increase of about 3% from current levels.

Bear Case:

- Everything we were worried about in 2023 actually happens in 2024. 2023 wasn't nearly as bad as feared but all we did was postpone the inevitable.
- **Economic Growth Contracts** – Higher rates finally hit the economy hard and kill the expansion. The worst-in-decades rate hike cycle catches up which slows growth in the first half and causes a contraction in the second half of 2024. No mild slowdown.
- **Inflation Stabilizes but Doesn't Meaningfully Decline** – The easy part is over. After peaking at 9%, inflation makes its way to 3-4% but gets stuck. The Fed is boxed in by inflation and rates stay high and do not decline.
- **The Fed Doesn't Cut Rates As-Expected and Rates Are Higher for Longer** – Inflation stays comfortably about the Fed's target of 2%, they don't cut rates and growth suffers causing an economic contraction. Net result is Stagflation.
- **Corporate Earnings** – The 10% earnings growth factored in for 2024 doesn't happen. Earnings disappoint which leads to a lower market multiple which is further complicated by higher rate which also put pressure on multiples. The S&P 500 declines 16% from current levels to 3800, where it started 2023.

Base Case:

- **Very rarely do things work out as-planned** – Outcomes are not binary. What usually ends up happening is you get a combination of the two vastly different outcomes. Could 2024 just be a return to "normal" where we get more pronounced volatility but drift higher?
- **Economic Growth** – Growth is clearly slowing down as we go in to 2024. I know that Q3 2023 GDP came in above forecasts but that is yesterday's data. Growth slows, slightly contracts but we do not go into a deep recession. Think the 1991/1992 recession for those old enough to recall. Inflation finally catches up with the consumer and dampens spending. A severe recession is less likely due to The Fed's massive balance sheet which provides an economic buffer. The labor markets weaken but doesn't collapse. The historically low unemployment

rate of <4% provides an additional cushion against a severe contraction. People that have jobs have money and that money gets spent and makes it into the economy.

- **Fed Rate Cuts** – The Fed is in no hurry to cut rates and repeat the mistakes of Fed Chair Author Burns in the 1970's who cut rates too early only to see inflation come back hard and helped top cause a rampant return of inflation in the mid 1970's. Market expectations of rates coming down in the first half of 2024 are too optimistic. This will cause yields to level off from their recent retreat from 5% on the 10 Year Treasury.
- **Earnings** – Earnings will grow in 2024 but not at the 10% rate the market expects. The slowing of growth will depress general consumer spending which will cause companies to reduce prices across the board. Companies have enjoyed great pricing power of the last 3 years and that tailwind will become a headwind as we go through 2024. Prices on goods from airline tickets to hotels will decline eating in to profit margins. The markets barley budge in 2024 and end largely where they began. No growth.

To summarize, we are neither raging bulls or raging bears. As Brian Wesbury at First Trust puts it, we are in the midst of a Muddle Through Economy. Not great but not terrible. With the huge rally we have experienced so far in Q4 2023, we may be pulling forward our 2024 returns which will make it tougher for the averages to make much headway. Diversification, sector weightings and asset class selection will matter more. So far, falling yields have helped stocks in late 2023. If those falling yields beginning to fall as a result of economic weakness, this will result in falling stock prices. This is an environment where fixed income investors will be rewarded.

Assuming our Middle-Of-The-Road outlook holds, what asset classes will outperform? Here is our take:

- **Bonds** – Longer duration fixed income with a focus on higher quality. In just about every scenario, bond yields will drift sideways or decline and this is good for coupon clipping (yield) or collecting a coupon and having your bond prices appreciate due to declining yields.
- **High Quality Equities** – High free cash flow, limited leverage and high return on assets. Think U.S. Large Company Value. Value has been left in the cold for the past couple of years (after a strong 2021 it was pretty flat in 2022/2023 which some would consider a win). Dividend paying stocks should flourish. Defensive sectors such as healthcare, utilities, REIT's & staples).
- **Alternative Asset Classes** – Asset classes that do not correlate to stocks or bonds.

We hope you have enjoyed this extensive analysis of how we are projecting the markets in the next year or so. Don't forget, there's a Presidential election in 2024 which will most likely add to near-term volatility but as usual, we often see a bit of a relief rally once that has concluded with a winner and either a continuation of the current administration or the advent of a new administration. In politics, you never know and predicting things 11 months out is a fool's errand.

Have a safe and happy holiday season. We look forward to 2024 – my 26th year in the business!

Regards,

Tim

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