Stranger in a Strange Landing: 2024 Outlook

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Ample analytical energy has been expended in the great debate about what kind of "Landing" the U.S. economy will experience in 2024.

Will it be a "Soft Landing" where growth remains relatively resilient as inflation falls? Or a "Hard Landing" where growth sputters and unemployment rises? Or a "No Landing" where both growth and inflation remain elevated?

These labels are assigned by investors with historical parallels in mind, like the idolized 1995 soft landing or the 1970s double inflation peaks, grasping to find some semblance of familiarity in this *strange* post-pandemic economy.

Much like Michael Smith, of Robert A. Heinlein's 1961 *Stranger in a Strange Land*, who is a human raised by Martians and arrives on Earth for the first time as a young adult, we find ourselves in a place, or an economy, where we have never really been before.

Though we are nearly four years beyond the pandemic and its unprecedented policy response, the long-tail impacts of 2020's events are still being felt, resulting in an economic cycle with scant historical similarities and filled with data dislocations, cycle discordance, and policy distortions.

The strangeness of the post-pandemic economy has caused substantial dislocations in economic and market data.

A stark and broad example is the **Conference Board's** Leading Economic Indicator (LEI), which is a collection of economic and market data that is expected to "move before changes in the overall economy", though it is actually **proven to be more coincidental** than leading. Regardless of the timing, the LEI has rarely been so persistently wrong about the real economy; the LEI has been negative for 18 months and remains at lows not seen since the recessions in 2000, 2008, and 2020, all the while U.S. GDP growth has been robust and above trend.

These data dislocations veritably broke economic forecasting in 2023, with consensus incorrectly predicting the recession-that-never-was. Models struggled to differentiate between slowing data that was simply normalizing from pandemic disruptions, and slowing data that was signaling outright economic weakness. Soft/sentiment data flashed warning signs all year, while hard/real data remained resilient. Classic bond market signals about the future path of growth and policy, such as yield curve inversions, were misleading, distorted by the long tail of unprecedented central bank crisis intervention.

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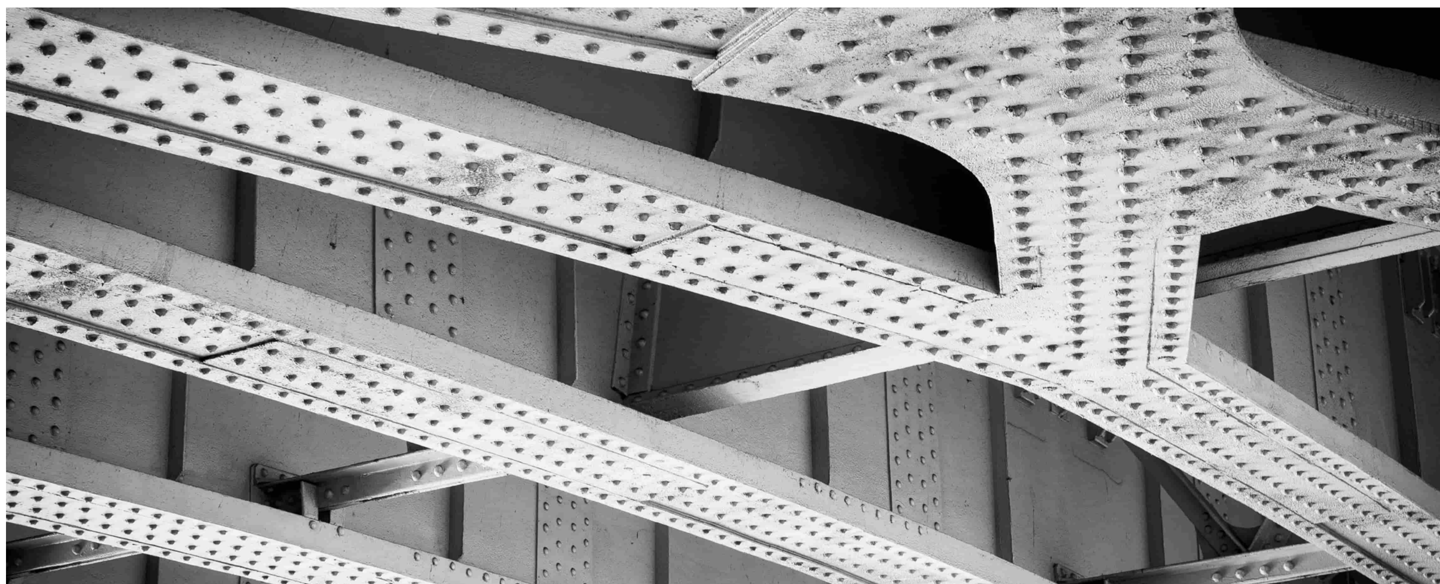

It was not just yield curves that were distorted by the long tail of aggressive policy intervention, it was also the entire reaction function of corporate and consumer balance sheets to higher rates. In a *strange* paradox, corporate net interest expense fell in 2023 as the Fed was raising rates (**BEA data**). After locking in low rates through the QE era, aggregate corporations have benefitted more from the rise in interest income than they have been hurt by higher interest expense as interest rates have risen.

This strange cycle has also been characterized by pockets of the economy experiencing discordant cycles, with some areas experiencing sharp weakness, such as manufacturing and transportation, and other areas experiencing robust strength, such as consumer services. The disjointed cycling of parts of the economy sets 2024 up for further uncorrelated rebounds and deteriorations.

All of this dislocation and discordance resulted in conflicting data signals in 2023, where subsets of data could tell very different stories about the outlook for the economy. This conflict persists in 2024; for something as important and closely watched as the U.S. labor market, sharply different narratives can be spun about the future outlook for U.S. employment depending on which subset of disagreeing data is used.

To add to the melee of data as we enter 2024, the policy backdrop is unique as well, with the potential for a rare non-recessionary boost from both fiscal and monetary policy.

U.S. fiscal deficit spending as a percentage of GDP remains near levels not seen outside of recessions or wars, while the Federal Reserve is expected to embark on an easing cycle, which at current market pricing implies the largest non-recessionary easing cycle in 40 years (not long after it completed its most rapid hiking cycle in 40 years!).

So instead of Soft, Hard, or No Landing, we posit that 2024 will be a Strange Landing, one filled with continued data dislocations, cycle discordance, and policy distortions.

***A Strange Landing* is one of potentially sudden changes to data, unexpected market reactions, and a wide range of narratives and prices across asset classes.**

We continue to see opportunity created by disruption in investment/asset classes that have faced headwinds in recent years.

In order to traverse this *Strange Landing*, investors should adopt the following traits (which also happen to be great traits for astronauts):

- **Vigilance:** Complacency could be dangerous in 2024, either by extrapolating recent trends in important data, such as U.S. labor market data, or ignoring "crowded consensus" in market positioning and sentiment (whether we look at equities, credit, or the pricing of Fed rate cuts). One-sided market pricing/narrative that ignores upside or downside risk should be questioned with vigilance.
- **Selectivity:** We see potential for strong returns in selective areas in 2024, with a wide gap between winners and losers across asset classes. Though incrementally easier, the policy backdrop does not support a "rising tide lifts all boats" approach, meaning quality remains key across asset classes. We continue to see opportunity created by disruption in investments/asset classes that have faced headwinds in recent years.
- **Responsiveness:** Data may change quickly over the course of 2024 so outlooks/forecasts will need to respond. Further, we see the potential for wide trading ranges instead of trends over the course of 2024, creating opportunities for investors to be tactically responsive, if appropriate.

It is this last trait that makes us journey from sci-fi to stoicism in finding our market mantra for 2024, a phrase that will be imperative to keep in mind throughout this strange, but fascinating year. Quoting the Greek Stoic philosopher Epictetus:

"It is not what happens to you, but how you react to it that matters."

When it comes to investing, and the inevitable emotion that comes with market volatility, the best reactions are often those that are planned well in advance and not done in the heat of the moment.

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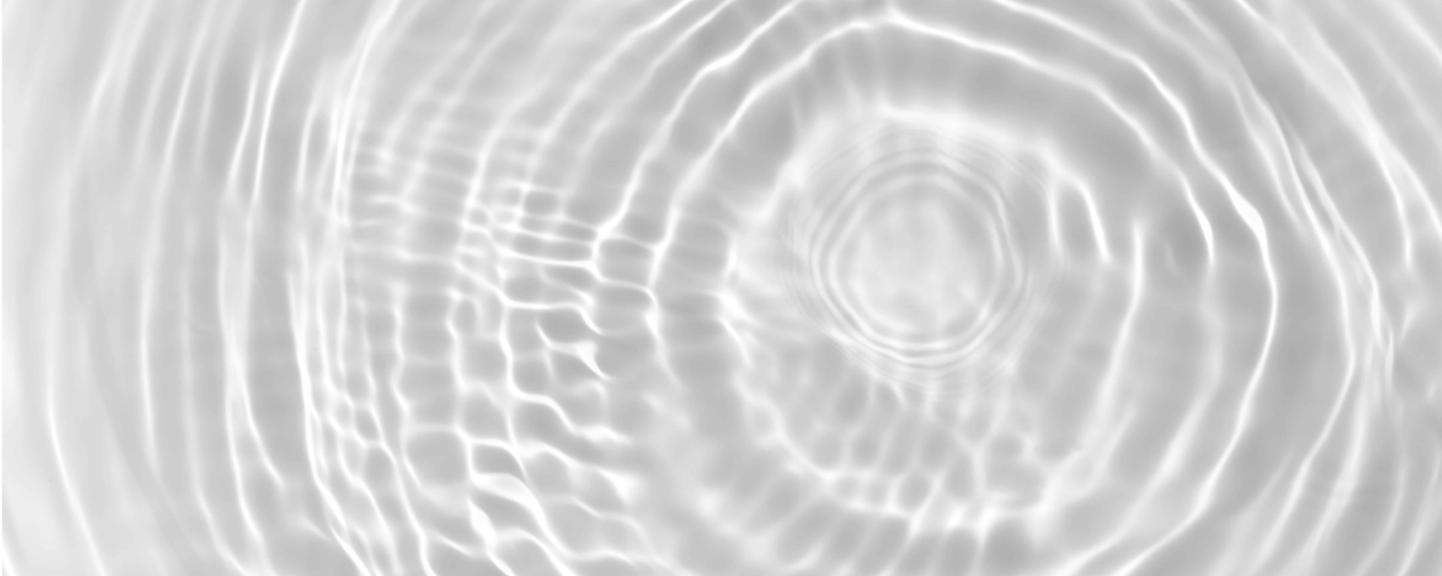

Tactically, a planned reaction could be having a strategy as to how to respond to/take advantage of eventual equity or bond market volatility (to the upside or downside). Strategically, a planned reaction is maintaining or progressing towards a long-term target asset allocation, despite emotional swings, as determined through a robust wealth strategy process. Overall, a planned reaction is identifying what you can control so that you can minimize the negative impact/maximize the positive impact of what you cannot control.

And so, strapping on a space suit toga, we enter 2024 armed with Epictetus to help us navigate an economic and market landscape that could even challenge the imagination of Heinlein.

Welcome, to the *Strange Landing* of 2024.

To view our 2024 Outlook Slide Deck and the outlook replay, please click the buttons below. Continue reading for a brief summary of our expectations for 2024.

2024 Outlook Slide Deck | Watch the Outlook Replay

Brief Summary of Expectations for 2024:

Written by Cameron Dawson, Jay Peters, Ben Emons, Kevin McIntyre, Maxwell Snyder, Chloe Reed, & Michaelangelo Dooley

U.S. Economy

- **Recession:** We do not expect a recession in 1H24 and will continue to monitor data for any signs of weakness building into 2H24 or 2025.
- **GDP/Labor:** We see initial upside to consensus forecasts for 1.3% real GDP growth in 2024 boosted by a still-tight labor market and real wage growth supporting consumer spending, fiscal policy support, and easy financial conditions.
- **Inflation:** We expect inflation to continue to moderate back towards 2% in the near-term, with factors like oil prices, shipping costs, the US dollar, and wages as possible sources of upside to inflation readings later in 2024. Potential recoveries in manufacturing and housing should also be monitored.

- **Watch Items:** Easing in peripheral labor data should be watched closely for signs of broader labor easing (which would likely hamper consumer spending); geopolitical tensions and elections could impact commodity prices and risk appetite.

Monetary and Fiscal Policy

- **Federal Reserve:** Assuming a resilient economy, we expect the Fed to tweak policy rates lower (three cuts equaling 75 bps), while we see market forecasts for much more easing (7.5 cuts priced in by January 2025) as too aggressive unless a recession is experienced. A review of the path of Quantitative Tightening (QT) (shrinking of the Fed's balance sheet) has already been previewed by the Fed and sets up for pause in QT in 2024.

- **Treasury:** We do not expect substantial change to the deficit trajectory given 2024 is an election year and agree with forecasts for a substantial increase in Treasury coupon bond issuance in 2024 (potentially +20% YoY), as Treasury faces the need to fund large deficits and potentially reduce the reliance on Treasury Bills. These Treasury funding decisions interplay with QT, as they will impact bank reserves and broader liquidity, thus influencing risk assets as well.

- **Watch Items:** A reacceleration in growth/inflation could cause a rapid repricing of easy Fed expectations; Treasury decisions about its cash balance and mix/timing of funding could have major market impacts; 2024 election results could influence the market's outlook for future deficit spending.

Equities

- **Range Not Trend:** We expect a wide trading range for the S&P 500 over the course of 2024, noting Bear (4,200) and Bull (5,200) cases both have reasonable assumptions, implying that both targets could be neared during the year.

  - Bear (4,200): Assumes slight downside to EPS estimates for 2024-2025 (softer economic growth), and a return to average PE valuations (which implies a tighter liquidity environment and/or risk-off appetite).

  - Bull (5,200): Assumes slight upside to EPS estimates for 2024-2025 (stronger economic growth and improved productivity) and maintaining current elevated valuations (which implies a continuation of easy liquidity and support from the Fed, with risk-on appetite persisting), potentially from a positioning chase/melt-up.

- **EPS:** Current forecasts for S&P 500 EPS, +11% in 2024 and +10% in 2025, are rosy given the underlying assumption of acceleration revenue growth (in a decelerating nominal GDP environment) and a return to record operating margins (with hopes for a productivity boom reflected in estimates).

- **Valuation:** Starting 2024 at elevated valuations leaves much less room for upside driven by valuation re-rating (the biggest driver of 2023 returns); for valuations to re-rate substantially higher, a significant easing in policy would likely need to materialize; the downside to valuations would be driven by tighter liquidity or shift to risk-off sentiment.

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- **Positioning Notes:** Selectivity is key with greater dispersion in returns experienced in laggard indices (Value, Small Caps, International/EM); quality remains imperative given the late-cycle nature of the economy and continued economic uncertainty.
- **Watch Items:** Technicals (late 2023 breadth/momentum thrust suggests strong forward returns), earnings revisions (watch 2025 progression, with a revision downcycle a key risk), evidence of technology impact (EPS impact of AI has been narrow thus far, is 2024 the year it broadens out?), positioning/sentiment (one-sided bullish positioning/sentiment could become a key risk for further upside), liquidity (Treasury liquidity could flip to be a headwind in 2024, even as the Fed is cutting rates).

Fixed Income

Overall, we expect a wide range for yields and spreads in 2024. We think investors will need to be alert to future rate volatility, especially with the market anticipating a major change in monetary policy, followed by a fast-approaching national election. We believe investors will be rewarded by adhering to a "buy the dip" mentality when, and if, this rate volatility occurs.

- **2-Year Treasury Yield:** Similar to 2023, we expect a wide range for the 2-year in 2024 of 3.5% to 5.25%. The lower end of this range would come with weakening economic data that pushes the Fed to cut rates more swiftly. The higher end of the range would come with resilient economic data, and upside to inflation, that keeps the Fed in a higher-for-longer stance.
- **10-Year Treasury Yield:** We see a wide range for the 10-Year yield in 2024 of 3.4% to 5%. In the near term, yields could be upwardly biased due to resilient growth data that does not support the bond market's current expectations of easy Fed policy, while increased Treasury issuance of coupon debt could pressure yields higher as well. Downward pressure on rates could be driven by the end of Quantitative Tightening, low inflation prints, and a deterioration in growth, which could spark a flight to quality.

> **We believe investors will be rewarded by adhering to a "buy the dip" mentality when, and if, this rate volatility occurs.**

- **Investment Grade:** We expect a range for IG credit spreads of 110-200 bps in 2024 (Baa Corporate Spread over Treasuries), with a base case for wider investment grade spreads caused by larger issuance, a steeper Treasury curve, and rising default rates.
- **High Yield:** We see a range for the High Yield Index option-adjusted spread (OAS) of 400 to 650 bps for 2024. This implies the potential for spreads to widen from current levels. The default rate and weak sectors like healthcare can contribute to the widening of HY spreads. The risk-on sentiment in equities on rate cuts and soft landing could push spreads lower towards 350 bps (the 2021 lows), but this level would not reflect the coming refinancing risks faced by high-yield borrowers in 2025.
- **Munis:** The municipal yield curve currently presents attractive opportunities, using a barbell maturity structure to capitalize on high front end and intermediate yields which provides less rate risk and a potential for total return. We consider taxable alternatives if looking at 2-10 years. In 2024, look opportunistically for A rated and BBB rated securities as spreads remain attractive.

Alternatives Private Markets

- **Our Overall Sentiment is Cautious Optimism:** We are cautiously optimistic throughout private markets as we believe dispersion across managers will continue to widen manager selection and quality of returns will increasingly matter. Manager selection matters.
- **Opportunity in Disruption:** We believe a number of the asset classes experiencing disruption like commercial real estate will present unique opportunities to buy high quality assets at incredible discounts.
- **Positioning:** Selectivity is key. We believe there will be bifurcation across markets as assets that have been held in funds and relatively unmarked for years are forced to market as they see liquidity. As the adage goes, we will finally see who was secure as the tide goes out.
- **Watch Items:**
  - **Private Equity Valuations From Previous Fund Vintages:** Private equity firms who have held off deals for the last few years in hopes of a better exit environment will see a widespread reconning with market pricing for these assets.
  - **Potential Cracks in Private Credit:** As we have called for a golden age for some, we will start to see which firms' underwriting was strong and which firms offered lenient structures in order to get deals done.
  - Real estate balance sheets renewed focus as the distress of balance sheets comes due and options to "extend and pretend" are exhausted.
  - **Early-stage Venture:** We continue to believe early-stage venture will outperform on the back of a significant shift in technology with AI and automation playing a more significant role in overall company efficiency.
  - **Growth Equity Starting to See Green Shoots**: We believe there will be an emerging opportunity to access strong, battle-tested companies, at better valuations.

Alternatives Volatility Strategies

- **Hedge Funds:** While broad hedge funds continue to post middling after-tax returns, we are excited about the potential for tax-deferred and tax-exempt structures to capture enhanced and uncorrelated after-tax returns.
- **Structured Notes:** After declining and remaining subdued for much of 2023, volatility could rebound in 2024 in sharp episodes, mostly if economic data does not align with current consensus pricing for a soft landing and easy Fed. Defensively positioned notes can do well in this environment, as they have the potential to achieve positive returns, even if index performance is flat to negative. Issuers have maintained stable credit ratings, with a meaningful moderation in perceived default risk from the 1Q/2Q23 highs. Issuer diversification and continuous health-checks are still a prudent strategy to mitigate credit risk.

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