Key Wealth Institute

2024 Outlook: On the Road (Back) to the Old Normal

By George Mateyo, Chief Investment Officer; Stephen Hoedt, Head of Equities; and Rajeev Sharma, Head of Fixed Income

Prologue

Our outlook begins by going back 15 years, for two days before Thanksgiving in 2008, the Federal Reserve (the Fed) issued a carefully crafted press release that would profoundly alter the capital markets for nearly a generation to come. By going back in time, one can better understand inflation (and thus interest rates) and its impact on asset prices (and thus one's portfolio), and where we might be heading next.

On this date, in a mere 189 words, the Fed announced an unconventional and a largely untested new program under which it would purchase longer dated and less liquid fixed income securities directly from external institutions.

More specifically, the US Central Bank announced it would be purchasing $100 billion of debt obligations issued by several housing-related government-affiliated entities, plus an additional $500 billion of mortgage-backed securities. As justification to this unorthodox action, the Fed explained, "These actions are being taken to reduce the cost and increase the availability of credit for the purchase of houses which should support housing markets and foster improved conditions in financial markets more generally." Soon thereafter, as to suggest that this new program would not go on forever, Ben Bernanke (then Fed Chairman) asserted, "At some point, the Federal Reserve will unwind its various lending programs."

Two weeks later, however, Bernanke and his colleagues altered their position by avowing, "The Federal Reserve stands ready to expand the quantity of purchases and the duration of the program as conditions warrant." And a month thereafter, the Fed did just that: its purchase programs were expanded threefold. This marked the beginning of what economists refer to as quantitative easing (or QE), inaugurating a new era of ultra-accommodative monetary policy (also known as cheap money).

In the months prior to activating QE, the Fed lowered interest rates aggressively in hopes of arresting the decline in the real estate market and minimizing the social and economic impacts caused by a recession, aggressively deploying conventional monetary policy tools. In fact, interest rates were lowered to zero, where they remained for the ensuing seven years.

However, as the mortgage market meltdown worsened and the Global Financial Crisis (GFC) widened, Bernanke and team were compelled to create and utilize new tools such as QE. QE differs from traditional monetary policy in that QE entails the Federal Reserve buying longer-term, less-liquid and, all else equal, riskier securities. To pay for these securities, the Fed uses its balance sheet, which can be expanded as necessary. From 2008 to 2015, the balance sheet ballooned more than four times in size from just under $1 trillion to over $4.5 trillion.

In 2015, upon concluding that the economy could stand on its own again, the Fed began gradually raising interest rates. By mid-2019, interest rates had increased roughly 250 basis points (2.5%), or about one-half of one percent per year, a rather meager amount relative to other rate-hiking cycles. Meanwhile, the amount of QE remained in place well after the Fed started raising interest rates. By mid-2019, its balance sheet still hovered near $4 trillion and still four times as large as it was 11 years earlier.

A few short months later, a previously unheard-of virus would quickly morph into a global pandemic prompting massive shutdowns throughout the economy, which triggered a huge contraction in both output and demand. In response, the Fed reverted to its GFC playbook: interest rates were quickly slashed back to zero.

Concurrently, and seemingly with little hesitation, stimulus checks were disbursed by the US Department of the Treasury, and the Fed supplied more than $2 trillion in lending support to households, businesses, and government agencies. In so doing, it commenced yet another round of QE (QE4), resulting in its balance sheet mushrooming once again, this time swelling by nearly 70% in two months to more than $7 trillion, a number that would grow for two more years before peaking at nearly $9 trillion in mid-2022.

To put this into context, in the course of 15 years, the balance sheet of the Federal Reserve was expanded by an amount commensurate with the combined size of the entire economy of both Germany and Japan, the world's third and fourth largest economies, respectively.

When QE was first announced in late-2008, several people feared it would trigger runaway inflation that would prove difficult to contain once unleashed. In actuality, however, after declining in 2009 for the first time in six decades, inflation rose by 2% in 2010 and accelerated up to more than 3% in 2011. The following year, however, the inflation rate declined, and in the subsequent decade, inflation would barely rise faster than 2%. Interest rates would also remain very low as the Fed saw little reason to respond with inflation ostensibly under control.

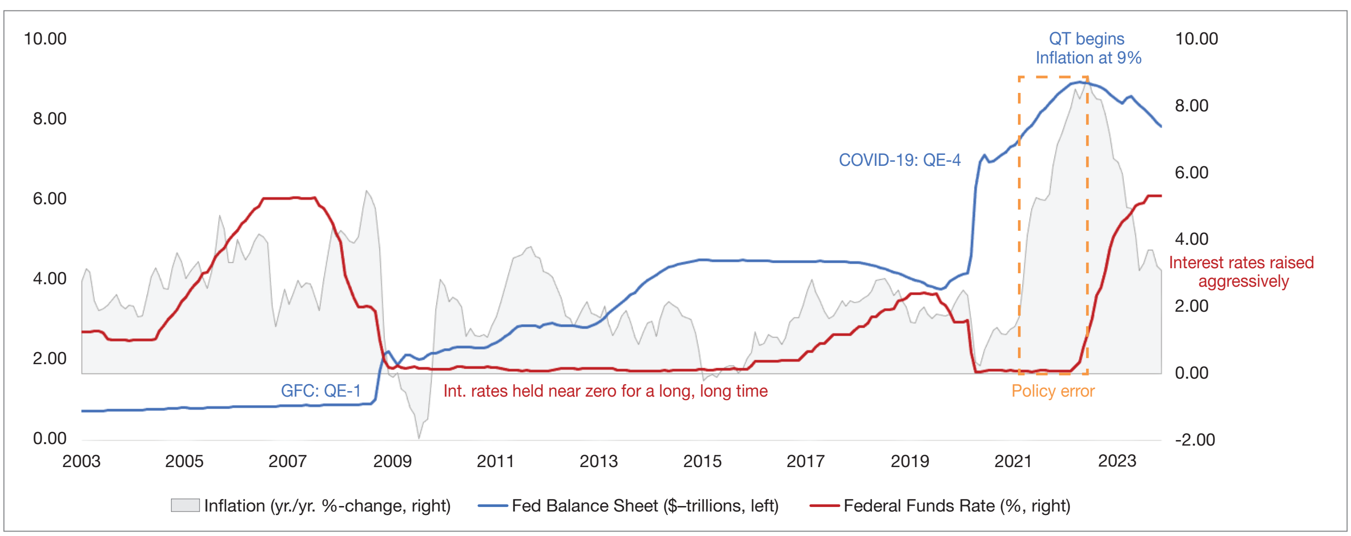
With borrowing costs exceptionally low and financing readily available, corporate profits boomed, defaults and bankruptcies declined, and the US experienced its longest economic expansion on record. COVID-19, and the policy response from both the Federal Reserve and the federal government, brought this cycle to an end, once again altering the capital markets for years to come.

In retrospect, the QE toolkit utilized during the Global Financial Crisis helped restore economic growth without igniting inflation. When it was deployed in the aftermath of COVID-19, however, QE had a different result — growth boomed but inflation did too.

The different reaction can be attributed to the fact that the GFC was a demand-based recession. Growth fell and remained relatively low because demand was relatively low as consumers, businesses, and governments needed to repair their balance sheets. Simply put, there was too little demand chasing a sufficient amount of goods.

The COVID-19 recession, on the other hand, was a supply-side recession exacerbated by an explosion in demand funded by stimulus checks. And thus, while QE helped restore demand, because of supply constraints, there was too much demand chasing too few goods. Said even more plainly, the Fed was right to act aggressively. In fact, we believe they are to be commended for their initial and swift response. However, one might argue that they committed a policy error by leaving QE in place for too long, and the economy is still adjusting to their decisions.

Chart 1 — The Fed's Balance Sheet, the Federal Funds Rate, and Inflation



Source: Federal Reserve of St. Louis and Key Wealth

"Admitting we are wrong is a sign of courage, not weakness"

— Roy Bennett

In January 2021, with COVID-19 still impacting daily life and the economy still healing, inflation grew by 1.4%. One year later, inflation (as measured by the Consumer Price Index) grew by nearly 8%, the fastest pace in 40 years, affirming the view we espoused in our 2022 Outlook **"Hot, Crowded and Flat"** that "inflation posed the biggest macro risk to the economy."

For much of 2021, Jay Powell (nominated to serve as Federal Reserve Chair by President Trump and then renominated by President Biden) described inflation as "transitory," believing it would fall as quickly as it rose, and thus, the Fed would not have to take steps to bring it under control.

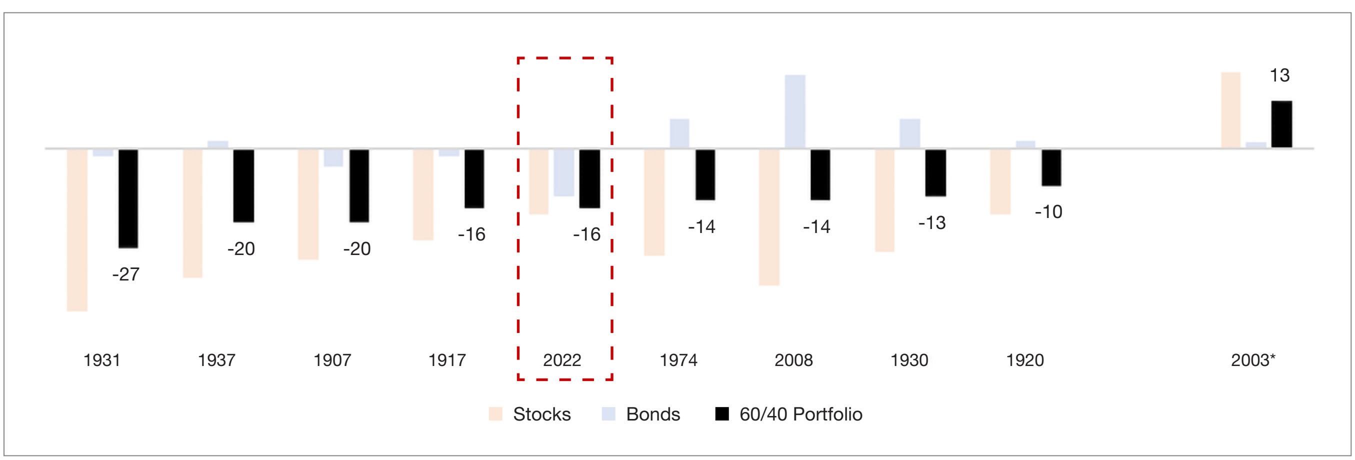
But by late 2021, Powell recognized he was wrong and that the term "transitory" should be retired. "I think that the data we got toward the end of fall was a strong signal that inflation is more persistent and higher, and that the risk of it remaining *higher for longer* has grown," he said in November 2021. And with that, having pivoted in 2019 by lowering interest rates and then pivoting in 2020 in response to COVID-19, Powell pivoted once more by vigorously raising interest rates and gradually shrinking the Fed's balance sheet via Quantitative Tightening (QT, the inverse of QE).

In total, interest rates were increased 525 basis points (5.25%), one of the largest cumulative interest rate increases ever. Further, these rate hikes occurred over an incredibly compressed amount of time. In other words, **interest rates were raised significantly and rapidly.**

There is an old investment adage that states, **"The Fed raises rates until something breaks."** Based on the performance of the financial markets in 2022, many investors were justified in feeling as if something broke. To wit, US stocks, as measured by the S&P 500 Index, fell more than 18%; international equities registered declines on par with their US counterparts; value stocks fared better, but still declined; and stocks of high-growth companies (whose valuations are more sensitive to interest rates) lost nearly one-third of their value. It was a very tough year for equity investors.

But perhaps the bigger source of pain in 2022 stemmed from losses experienced by most bond investors, encapsulated by a 13% drop in the most widely used bond market benchmark. Investment grade corporate bonds fell even more (18%), and long-dated bonds sank by 25%, capping off one of the worst years in history. Moreover, bonds failed to provide diversification at a time when it was needed most, prompting many to proclaim, "A classic investment strategy has fallen apart." This was with good reason: A portfolio with 60% allocated to Large Cap US stocks and 40% allocated to investment-grade bonds retreated 16% in 2022, the fifth-worst 12-month return for a balanced portfolio in more than 100 years.

Chart 2 — Annual Returns (%)



YTD returns as of November 30, 2023. Source(s): Bloomberg; Key Wealth.

Despite this drubbing (caused in large part by the Fed's interest rate hiking campaign), when 2022 ended, inflation had only receded moderately, falling from its zenith of 9% in the summer of that year to 6.5% at year's end. This was welcomed progress for sure, but still glaringly above 2%, the inflation target repeatedly reiterated by the Federal Reserve. This fact prompted us to ask a year ago: Metaphorically speaking, **was a pound of medicine administered by the Fed to squash inflation worth an ounce of cure?** [a play on the advice offered by Ben Franklin: "An ounce of medicine is worth a pound of cure."] **Our answer: Probably not.**

Furthermore, as 2022 drew to a close, other challenges had emerged. The Ukraine war was approaching its one-year anniversary with no imminent signs of peace; Europe was facing immense energy pressures; and China's zero-COVID policy was not only taking a large toll on the global economy, but it was also fueling domestic tensions, the likes of which had not been seen in more than three decades.

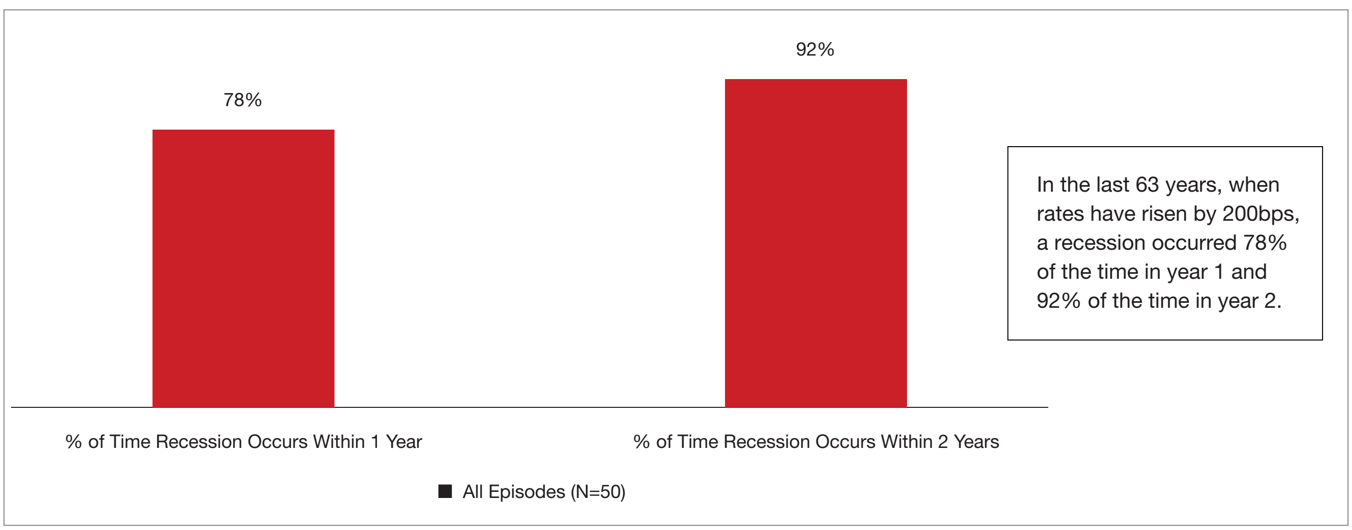
In short, 2023 began with many investors feeling rather glum.

Economists were also in a somber mood, with one forecaster assigning a probability of 100% that the US would suffer a recession in 2023. We were far less pessimistic, but historically a rising rate environment usually warrants caution.

As proof, a well-known investment firm analyzed 50 episodes in which interest rates rose more than 200 basis points (2%) cumulatively since 1960. Their conclusion was rather definitive: nearly 80% of the time, a recession occurred one year later, and more than 90% of the time, a recession occurred two years later.

The takeaway: Interest rates have historically acted as a potent economic headwind that typically causes financing to be curtailed, job losses to rise, spending to wane, and the economy to contract.

Chart 3 — What Happens When Interest Rates Move Higher? (an analysis of 50 episodes of +200bps in rates since 1960)



Historical performance does not indicate future results. Source: BWA; Key Wealth.

Had prognosticators foreseen a deepening of the Ukraine-Russian war, a war involving Israel and Hamas, persistently sluggish economic conditions in China, serious (but not systemic) fractures within the US banking sector, and extreme levels of volatility in the US Treasury market over concerns regarding the US debt and deficit situation, their already dismal view would have been even more pessimistic. **Yet, 2023 is ending on a note of optimism. Why, and is it warranted?**

The US economy exceeded expectations in 2023, caused principally by stronger-than-expected consumer spending which, in turn, was driven by higher wages, drawdowns of excess savings (i.e., leftover stimulus money), and modestly higher use of debt. To ascertain the future path of the economy, each requires some examination.

What lies ahead?
A return to the Old Normal.

With respect to wages, from 2009 to 2019, wages grew at approximately 2.5% per year. After swinging wildly between 2020 and 2021, wages have been slow to normalize, increasing by more than 6% in early 2022 and gradually falling to 4% as of this writing. Looking ahead, further moderation in wage growth seems likely. Although given labor disputes involving many industries and a large number of unfilled jobs, we do not foresee an outright decline in wages.

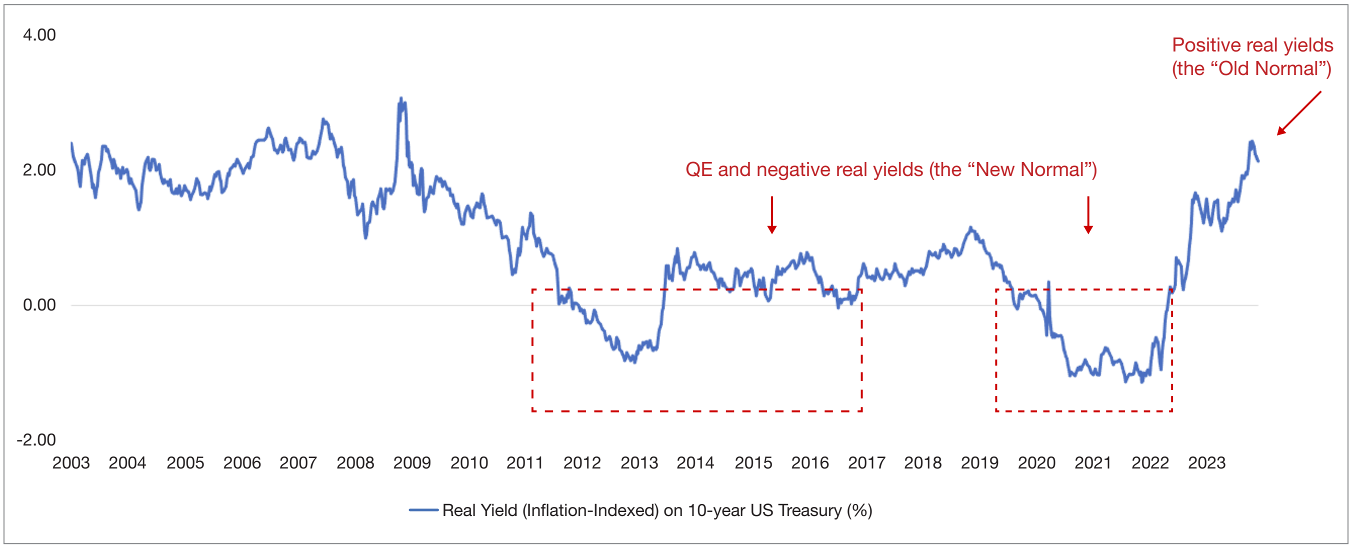
Wage growth will be especially important for future spending as consumers' excess savings have largely been depleted as depicted in the chart below. In effect, this may represent a return to the Old Normal, whereby economic distortions caused by COVID-19 and the policy response have largely dissolved. In addition, as consumers' savings have been drawing down, the use of credit has risen at the same time that the cost of credit has also risen appreciably. This, combined with the resumption of student loan payments affecting millions of borrowers, should curtail future spending.

That said, the overall balance sheet for the average consumer is still considerably less leveraged relative to the past, and while rising debt service ratios and some deterioration within some segments of consumer credit should be monitored closely, the overall health of the US consumer generally seems intact. Additional support exists from falling inflation translating into improved purchasing power, and if interest rates have peaked, this would suggest a slight easing in monetary tightening. These are key reasons to be cautiously optimistic about 2024, but the health of the consumer — and the strength of the labor market — will need close monitoring in the year ahead.

Chart 4 — Cumulative Excess Savings ($ – millions)

Source(s): Federal Reserve Bank of San Francisco; Key Wealth Institute

Chart 5 — **10-Year US Treasury Real Yield (%)**



Source(s): Federal Reserve Bank of St. Louis; Key Wealth Institute

Another example of the economy returning to the Old Normal can be observed by looking at real yields (i.e., interest rates adjusted for inflation). Interest rates are a critical variable of any economy as they serve as the price of money. During the Global Financial Crisis and the ensuing 10 years, as noted earlier, the price of money was exceptionally low, and borrowing was easy to secure. Even borrowers with sub-par credit scores and profitless businesses had little difficulty securing financing.

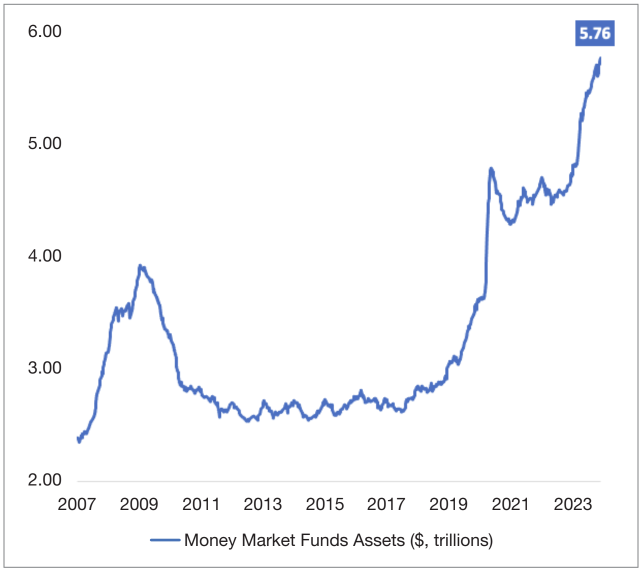
Once inflation took hold in 2021 and persisted into 2022, the Fed had to end its accommodative stance, cease QE, and raise interest rates dramatically to where real yields are again in positive territory.

Positive real yields suggest that a much more discerning lending environment may lay ahead of us. This could be compounded by the challenges facing the banking sector writ large as a result of greater regulatory scrutiny brought on by the issues that came to light in March 2023. Consequently, some borrowers will struggle, others may see their access to credit to shrink or disappear altogether, or some may discover that their cost to borrow has increased. As a result, some projects may not receive funding, some job openings may not be filled, and the economy could slow.

But this itself is not a reason to conclude a recession is immediately at hand as, prior to the GFC, the economy co-existed with positive real yields without issues. In fact, it may be worth viewing negative real yields as the exception and positive real yields as the norm.

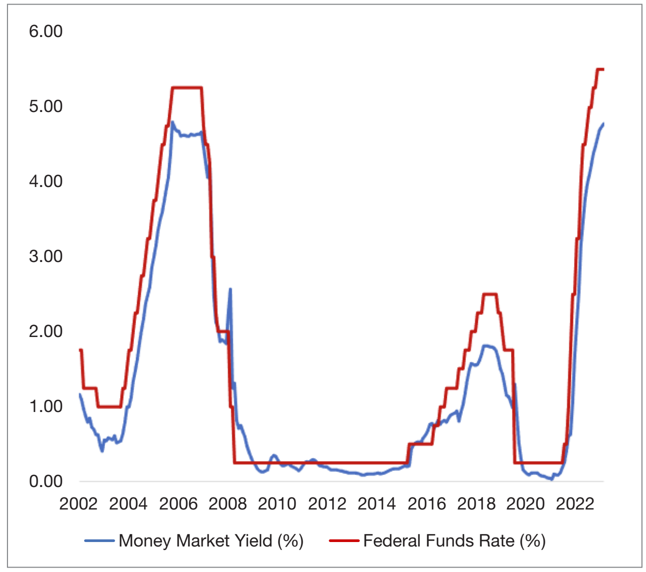
Furthermore, positive real yields could result in more rational decision making. At the same time, there is still a considerable amount of capital that has been raised over the past several years in the private markets, just as there is an immense amount of money residing in money market funds and other short-term investment vehicles (see Chart 6 on page 8). These are important sources of "dry powder" that could lessen some of the negative impacts associated with a reduction in financing from traditional sources.

Chart 6 — Money Market Fund Assets ($ – trillions)



Source(s): Federal Reserve Bank of St. Louis; Key Wealth Institute

Chart 7 — Money Market & The Federal Funds Rate (%)



Source(s): Federal Reserve Bank of St. Louis; Key Wealth Institute

Tying it all together

In response to COVID-19, the Federal Reserve unleashed unprecedented liquidity into the economy to stem the pernicious effects of a massive decline in demand. Supply constraints also quickly surfaced during the pandemic. Combined with a relatively rapid resumption in demand in addition to significant amounts of stimulus provided by fiscal authorities, an inflationary impulse not seen in more than a generation was sparked.

As inflation took hold, policymakers initially (and incorrectly) characterized it as "transitory," believing it would fade as quickly as it rose. But it didn't. Inflation proved stickier than anticipated, validating a comment made by one central banker, "Inflation shoots out of a cannon but falls like a feather." Ultimately, however, the Fed recognized the errors of its ways and began an aggressive campaign to bring inflation back under control.

By applying "a pound of medicine," the initial response was "an ounce of cure," for while inflation moderated, its decline occurred very gradually. In 2023, more progress was achieved, but the patient is not completely healed and, in fact, additional medication might be needed.

Positively, inflation is receding, and additional moderation seems likely. We do not believe that inflation will quickly fall to and remain at or below the Fed's 2% target for a prolonged period of time, absent another economic shock that results in a spike in unemployment. We also do not believe that the Fed will reactivate QE anytime soon. Instead, the economy may firmly be on the road back to the Old Normal, with inflation likely to hover between 2% and 4%, versus the 0 – 2% range it occupied as QE was taking place. Additionally, we think that the Fed may place less emphasis on inflation in 2024 and shift its attention to the other half of its "dual mandate" — growth/employment.

COVID-19 and the post-COVID policy response triggered both a demand and a supply shock, knocking the economy off balance. In the past three years, the issues that initially tormented supply chains so considerably have largely receded, but demand shocks have not fully normalized.

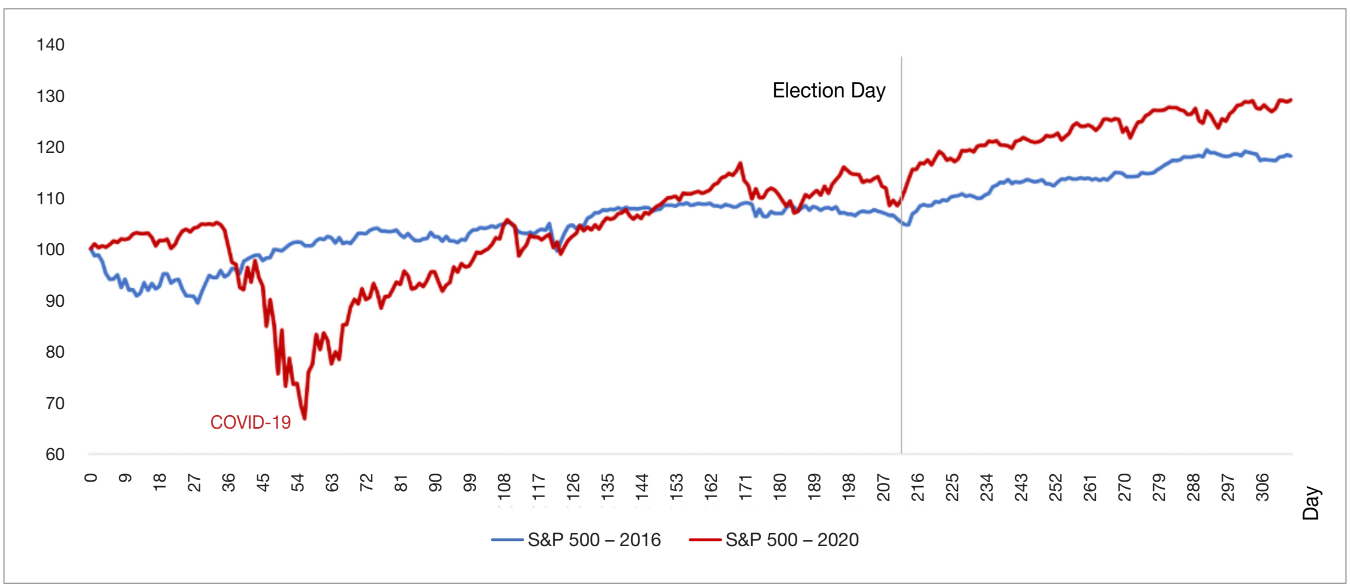
Perhaps one of the biggest imbalances that existed is the excess savings among consumers, which rose to more than $2 trillion at the height of the pandemic. Not only was this amount uncharacteristically huge, but it was also unprecedented to see savings swell amid a recession (typically savings are drawn down as the economy turns down). The presence of these savings also enabled the economy to exceed expectations in 2023, manifesting through robust consumer spending.

Today, these savings have diminished substantially, which should curtail future spending growth as well. Nevertheless, we remain cautiously optimistic that the economy can continue to expand so long as wage growth persists and the number of new jobs being created continues to grow.

Against this backdrop, we see corporate profits rising modestly in 2024, but stocks may experience some choppiness given current valuation levels, hints of some short-term complacency, and customary election-year dynamics. Historically, during election years (relative to non-election years), equity returns generally tend to be weaker. This observation, in large part, is due to outsized levels of volatility experienced in two of the more recent election years, which were influenced by non-political events including the Great Financial Crisis (2008) and COVID-19 (2020).

That important caveat said, in many election years, equity markets have generated respectable but not spectacular returns in the first half of the year, only then to meander sideways during the subsequent summer months, before sliding south between August and October. But once the election results were known, stocks typically stabilized and ultimately reverted higher in the months that followed.

Chart 8 — S&P 500 Index During Election Years (Jan. 1 = 100)



Historical performance does not indicate future results. Source(s): Key Wealth

Irrespective of what happens next November, we foresee modest upside for equities and believe stock market rallies should broaden out, benefiting the “other 493” in the S&P 500 Index relative to the “Magnificent Seven.”

Bonds, in our view, are also poised to add to recent gains, although we would caution that bonds may exhibit continued volatility for reasons beyond the Federal Reserve. Renewed concerns over our country’s overall indebtedness and budget deficits surfaced in mid-2023 and have since subsided, but the underlying issues behind these concerns have not been addressed, a potential source for the aforementioned volatility.

Still, we advise investors revisit their cash exposures and consider mildly extending duration relative to their fixed-income benchmarks. Balances of money market funds, as illustrated earlier, soared in 2023, and we acknowledge that there’s much to like in a +5% return on cash-like investments. The challenge, however, is that should the economic outlook worsen (or even if the Fed should so much as hint that it is once again altering its stance and contemplating cutting interest rates), money market yields could fall quickly, and high-quality bonds would likely rally.

Real assets also deserve inclusion in a well-diversified portfolio, in our view. Even though inflationary pressures may have eased, should the Old Normal thesis take hold, inflation protection is still necessary to help insulate a portfolio from unexpected or unwelcomed events.

For greater insights into our thoughts about the stock and bond markets, please be sure to review the accompanying outlooks penned by my exceptional colleagues Steve Hoedt and Rajeev Sharma.

In closing, the pessimism felt this time last year has been replaced with some recently discovered optimism as 2023 is drawing to a close. The contrarian in us views this recent shift in sentiment with skepticism, but on balance, despite numerous challenges and sources of uncertainty, our belief in human ingenuity continues to run deep.

On behalf of all of my amazing associates within Key Wealth, I wish you and your family a healthy, prosperous, and a fulfilling new year.

George Mateyo, Chief Investment Officer

2024 US Equity Outlook

While looking at the headline returns for US indices such as the S&P 500 would suggest that 2023 has been a banner year for stocks, the truth is much more complicated. Equity markets have confounded most investors, especially those that entered the year expecting a recession. Instead, the US economy powered ahead in the face of higher interest rates, driven largely by the robust American consumer. Why has the consumer been so vigorous in the face of calls for recession? We believe that the resilience has largely been driven by two factors: 1) world war-level fiscal spending supported by the Fed during COVID, which drove up excess savings, and 2) tight labor markets (i.e., higher wages) combined with moderating inflation to support above-average consumption.

Equity market performance was also dominated by a limited number of large-capitalization technology stocks that came to be known as the “Magnificent Seven,” fueled by optimism surrounding the possibilities for artificial intelligence (AI). We believe that AI has the potential to be a transformational force for growth across the wider economy, not just in the technology sector; however, we also think the market’s expectation regarding the impact AI will have is unrealistic. In our view, the full benefits from AI will accrue over three to five years. This is still a relatively quick ramp-up period for a new technology, but slower than the one- to two-year time horizon priced into the stocks of the Magnificent Seven this year. We believe in turn that this concentration of performance has created ample opportunity for research-driven investors, as the number of companies overlooked by market participants is larger when most of the attention is focused on a fortunate few. Given this, we believe in hindsight that **2023 will be viewed as a year when “the market” performed, yet most stocks did not.**

Finally, as we finish setting the stage for what 2024 might have in store for stocks, some pundits have drawn parallels with historic periods of market concentration in which stocks soared and then crashed, such as the "Nifty Fifty" era of the 1960s/70s or the crash in technology, media, and telecom stocks when the internet bubble popped in 2000. With this backdrop, pundits conclude that 2023's strong gains are a priori negative for markets in the near future.

We disagree and do not believe that concentration alone is a signal that the market has peaked. Both corporate fundamentals and valuations of the Magnificent Seven are more robust now than during these past phases of market concentration, given their superior expected sales growth, robust profit margins, solid re-investment ratios, and balance sheet strength. At the same time, their risk/reward profile is not particularly compelling today for investors due to elevated forward expectations. Given this, **2024 may very well be a year in which we see these market leaders "mark time."** The bears will need to look elsewhere for their sell rationale, in our view.

Looking ahead, we examine three reasonable scenarios for the progress of the S&P 500 Index during 2024. Our Base Case represents a most-likely scenario of continued moderating inflation and solid but sub-trend growth (aka a soft landing). In our Bull Case, we consider the possibility of a rebound in economic growth, and sticky inflation along with it. Our Bear Case is a delayed US recession, perhaps triggered by the lagged effect of monetary tightening and/or a resurgence of inflation.

Base Case

In our Base Case, we envision that the Federal Reserve has finished its interest rate hiking cycle and long-term US Treasury yields have peaked. However, solid economic growth means the Fed will remain on hold until the fourth quarter of 2024. This is in contrast with current market expectations that are pricing in interest rate cuts beginning in the second quarter of 2024. Our Base Case expects corporate revenue growth to be in line with nominal GDP growth, reflecting the macroeconomic expectations for current trends of slowing real GDP growth accompanied by continued moderating inflation. In this situation, we also expect corporate profit margins to remain broadly stable. This should allow firms to continue to post positive earnings growth in 2024 in the neighborhood of 5%.

While any decline in economic growth inevitably puts pressure on corporate profits, such a scenario should also offer some relief in the form of interest rate cuts by the Federal Reserve toward the end of 2024. We also assume real 10-year US Treasury yields will equal 2.3% at year-end 2024 compared with 2.2% today. This macro combination supports current price-to-earnings (P/E) multiples but leaves little room for expansion. Given this, our baseline scenario expects P/E ratios to stay around their current levels. We see this scenario as a typical late-cycle economic environment for stocks, equating with a target of 4700 likely for the S&P 500 at year's end.

Bull Case

What about a faster recovery, rather than a slowdown or recession? The Institute for Supply Management (ISM) Purchasing Managers Index (PMI), a measure of business confidence, provides us with some clues about what to expect in that scenario. Historically, there are two types of PMI slowdown: 1) recessions (ISM PMI levels of approximately 36) and 2) mid-cycle slowdowns (ISM PMI levels of roughly 46). When the ISM PMI bottoms, it historically peaks approximately 20 months later. If the recent ISM decline falls into the mid-cycle slowdown camp and June 2023 was the recent PMI low (46), then the timing tells us to expect a recovery into Q4 2024.

A re-acceleration in growth led by manufacturing might also suggest that inflation could rebound due to persistent wage pressures and that the Fed may not have finished its hiking cycle. At the same time, it is also unlikely to see the Fed raise rates aggressively either. If this broad-based acceleration in economic activity was also accompanied by corporate pricing power, we could see a step-function increase in earnings for the S&P 500. Still, multiples would likely contract modestly, reflecting higher costs of capital. In our view, this could take the index to 5000 by year-end 2024 in our Bull Case, roughly 4% above the all-time high of 4800 set in January 2022.

Bear Case

The consensus came into 2023 expecting a US recession, and it has perpetually revised its forecast throughout the year to expect a recession to start six months forward from whatever date currently shows on the calendar. While we believe that the risk of a recession has been reduced, it has not disappeared altogether. Maybe 2024 will finally see the arrival of the “most anticipated recession in history” driven by the cumulative impact of monetary tightening. Looking at history, from the early 1970s to the early 2000s, there was generally a lag of between six and 12 months until rate hikes began to impact real consumer spending. Over the past 20 years, real consumer spending has lagged by an even more extended 18 – 24 months. If so, we could be in for a rough year.

Historically, when the economy enters a recession, we have seen earnings for the S&P 500 Index decline 15% to 20%. At the same time, price-to-earnings multiples would likely rise in a recessionary scenario, as market participants look across the abyss and toward the inevitable recovery, helped in part by the Fed cutting rates sooner and more aggressively than in our Base Case scenario. Our Bear Case would expect the S&P 500 to trade at 3700 by the end of 2024.

Sectors

We employ a simple two-variable framework to help us understand which sectors and industries are likely to benefit from a particular macroeconomic backdrop. Those two variables are growth and inflation. These variables combine into four distinct configurations, which benefit different segments of the market:

1. Higher-than-expected growth with higher-than-expected inflation (Cyclical Value)
2. Higher-than-expected growth with lower-than-expected inflation (Cyclical Growth)
3. Lower-than-expected growth with higher-than-expected inflation (Defensive Value)
4. Lower-than-expected growth with lower-than-expected inflation (Defensive Growth)

We continue to expect stronger economic growth in 2024 along with stickier inflation, driving relative outperformance in Cyclical Value stocks such as Energy, Materials, Industrials, and Financials.

With yields on cash, money markets, and CDs at 15-year highs, investors have flocked to these low-risk instruments. We see a world in which inflation is likely to be structurally higher, suggesting that investors will need capital appreciation along with income to meet long-term goals. While cash may offer a compelling value proposition now, those yields will eventually fall when the Fed cuts rates. On the other hand, we believe that high-quality, dividend-paying stocks offer the potential for both income and capital appreciation. The emphasis in the prior sentence should be on the words "high-quality." Our research indicates that all dividend-paying stocks are clearly not the same, and it is imperative for investors to find dividend growers with strong balance sheets that can sustain payments through economic volatility, helping investors pursue their income goals.

Finally, we continue to advocate that investors hold a portfolio of high-quality Large Cap stocks throughout the market cycle. We believe that it is likely economic uncertainty will generally remain elevated next year, with geopolitics and the presidential election cycle having the potential to throw plenty of curve balls. This should continue to support the relative outperformance of stocks with quality attributes such as high profitability (return on equity, return on invested capital), strong balance sheets (debt/total capital), stable sales, and earnings growth, and low historical drawdown risk.

Small Caps

Given the focus on the Magnificent Seven and the concentration of performance in this limited subset of the market, investors could be forgiven if they have forgotten about Small Cap stocks; however, we think this segment of the market may be worth another look. Small Cap companies have near-record cash levels on their balance sheets, have lowered debt levels, and have access to capital. The high-yield market does not see the same level of stress as recent Small Cap underperformance implies, given that spreads are below their long-term average and issuance has been strong this year. Recession fears have receded, and "higher for longer" driven by better-than-expected economic growth actually helps Small Caps more than Large Caps. We have also seen the dollar weaken, which is a tailwind for more domestically oriented Small Caps. M&A activity has accelerated, is running ahead of its long-term average, and has broadened out across sectors, which is very favorable for this segment of the market.

We also believe the long-term case for Small Caps is bright due to a host of historical extremes. The recent underperformance by Small Caps took their rolling 5-year relative return down to the seventh percentile going back to 1930. This underperformance cycle relative to Large Caps is second longest in the history of Small Caps, which dates back to 1926. In fact, the cap size segment has now shrunk to less than 4% of the US equity market. On average it has been ~7.5% going back to the 1920s. It would not take much mean reversion to drive material outperformance. Couple this with the fact that literally everyone believes that the Magnificent Seven and mega caps are likely going to outperform forever, and you have the making of a contrarian trade. We see the risk/reward as compelling.

Conclusion

2024 is likely going to be a bumpy one for investors, with growth, inflation, the Fed, geopolitics, and the presidential election combining to create quite the "wall of worry" for the markets to climb. The year is most likely going to follow our Base Case scenario, which is a typical late-cycle economic environment for stocks, and we see the S&P 500 exiting the year at 4700. While this may not be the kind of stellar returns that investors have gotten used to, sometimes stocks need to "mark time" and digest gains. If the economy avoids recession, long-term strategic allocation to stocks should continue to prove rewarding in 2024.

Stephen Hoedt, Head of Equities

Fixed Income 2024 Outlook: Bonds Are Back

Interest rates sold off significantly in the second half of 2023, causing increased volatility for interest rate sensitive fixed-income asset classes. As we head into the new year, we believe that the US Federal Reserve is likely done with its rate hiking cycle and will maintain the Fed funds target range at 5.25% – 5.50% in the near term, as the Fed monitors the impact of tighter lending standards and financial conditions. The big question facing bond investors is whether rates will remain "higher for longer," as per the Fed narrative, or will an economic slowdown compel the Fed to begin cutting rates sometime during the second quarter of 2024. Historically, once the Fed reaches its peak policy rate, overall bond performance in the period afterward is quite favorable.

The short end of the yield curve is most sensitive to Fed policy. After 525 basis points of rate hikes, the Fed swaps market is suggesting that the Fed is done raising rates and is implying 100 bps of rate cuts by the end of 2024. However, the economy has remained resilient in the face of rising interest rates, leading to the Fed's conviction that achieving an economic soft landing is possible and maintaining the Fed funds rate at an elevated level for longer is warranted. This disconnect between market expectations for rate cuts and the Fed's stance of "higher for longer" will likely continue to lead to volatility in the rates market in the months ahead.

Beginning in 2022, we saw a surge in bond yields, specifically short-end yields, due to the Fed's rate hiking cycle. More recently, we had seen the long end of the yield curve move higher due, in part, to the increase in long-end supply by the US Treasury and a decline in demand by foreign buyers of US debt. The situation was exacerbated by the rating downgrade of US sovereign debt from AAA to AA+ earlier this year.

That said, most fixed-income asset classes are now providing the highest level of yield in 15 years. This is certainly good news for fixed-income investors who are searching for income and total return opportunities going into 2024.

If we focus on the long end of the yield curve, the premium that investors require for holding longer-dated bonds has increased over the second half of this year, and we do not expect the yield curve to invert significantly further. If the Fed does begin a rate easing cycle, we would expect the yield curve to begin steepening. We have seen increased demand from investors for longer-dated bonds when the 10-year Treasury yield approaches 5%. At this stage of the cycle, selectively adding duration to fixed-income portfolios will allow investors to "lock in" yields at attractive levels. In addition, total return opportunities would be even more pronounced if the economy weakens, as longer-dated Treasuries could be utilized as a hedge against downside risks.

Turning to the credit markets, we continue to see value in high-quality, investment-grade corporate bonds. At current yields, intermediate duration is particularly attractive for US corporate credit and should provide investors with total return opportunities and a defense against macro uncertainties. Investment-grade issuers have nearly $1.5 trillion in debt coming due between 2024 and 2028. However, investment-grade companies have strategically taken measures to shore up their balance sheets by reducing interest expenses when rates were low and term out (i.e., extend) funding needs to much longer maturities. They are now, in turn, better able to withstand rate volatility. Investment-grade bonds currently offer investors an opportunity to lock in yields close to 6%, and we feel that an overweight to corporate bonds over US Treasuries will be a prudent strategy for 2024.

In contrast, high-yield credit spreads are vulnerable to spread widening in the new year. High-yield issuers have close to $2 trillion in debt maturing between 2024 and 2028, and the most leveraged issuers will have to absorb a much higher interest rate burden to meet operating expenses. We expect this to cause a stress on the high-yield market, specifically bonds rated CCC (higher risk). This could lead to higher default rates for leveraged loans and high-yield bonds, spurred by higher rates and higher debt service costs.

There are significant opportunities in municipal bonds considering the effect of taxes, particularly in high-tax states, where tax-equivalent yields could provide investors with further incentives in 2024. Underlying fundamentals for high-quality municipal bonds are strong, however, we remain cautious of high-yield municipal bonds as yields here are not supportive of the additional risk associated with these issuers. In the case of an economic downturn, high-quality municipal bonds can provide a defense against the risks of a hard landing.

Overall, we are optimistic on fixed income as we go into the new year. We believe that with the Fed on hold, there is significant opportunity for bondholders to take advantage of a peak in rates and earn attractive coupon yields over the next year. While lower-rated bonds have outperformed in 2023, we would advocate for higher quality bonds with a focus on liquid securities. As short-term interest rates are expected to move lower, we would advocate a move out of cash and into bonds, and overall, we favor adding modest amounts of duration to lock in yields as we believe that high-quality fixed income will outperform cash at this stage of the monetary cycle.

Rajeev Sharma, Head of Fixed Income

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