

10 Predictions for 2024

Q3 2024 Update



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Introduction (Written December 2023)

The key economic question for 2024 is whether central banks can continue the “landing of the plane” (soft landing) without a crash (recession). The consensus view of 2024 is a Goldilocks environment of not too hot and not too cold. Expectations include a soft economic landing, a continued decline in inflation toward targets, and double-digit earnings growth. We think that fairy tale is unlikely, meaning either 1) the economy weakens enough for a bumpy ride (perhaps a recession) and earnings fall short (most likely), or 2) the economy remains strong enough to support double-digit earnings growth at the risk of little progress on inflation and Fed rate cuts. The long-predicted recession will likely materialize in 2024, although it most likely will be brief and shallow. The main arguments for a recession are the lagged effects of monetary tightening both via the Fed and long-term interest rates. While the absence of a recession thus far has increased market expectations for a soft landing, historical comparisons point out that a recession prior to this point would have been on the early side compared to history. Also, after the largest growth in the money supply since WWII (due to COVID-19), we are now experiencing the biggest decline since the 1930s. Can a productivity boom rescue the U.S. via AI, automation, and robotics? Only time will tell.

Key:



Heading in the right direction



Heading in the wrong direction



Too soon or too close to call

1
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The U.S. economy experiences a mild recession as the unemployment rate rises above 4.5%

The investment community has all but taken “recession” out of our vocabulary. Granted, economic growth has been more robust than just about anyone thought. We contend that a recession in 2023 was averted due to 1) the vast amount of excess savings generated during Covid (spent down significantly in 2023), 2) continued massive spending by the government, and 3) the emergence of private credit as a huge source of capital. Additionally, the lagged effects of the Fed’s aggressive interest rate increases, the lack of money growth, the inverted yield curve, and the record decline in Leading Economic Indicators tell us not to dismiss recession as a possibility later this year. The average amount of time from the first Fed increase to the onset of inflation has been reached, and there are signs (finally!) of economic slowing.

2
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The 2-3% inflation ceiling of the 2010s becomes the 2-3% inflation floor of the 2020s.

Inflation has remained sticky, especially service sector inflation. Granted, good productivity gains have lessened the impact of wage rate inflation. We continue to think inflation will fall further but very unlikely to the 2% level the Fed (and almost every other developed market central bank) desires.

3
✓

The Fed cuts rates fewer than the six times suggested by the Fed funds futures curve.

This prediction has certainly come our way. After entering the year with the Fed funds future curve suggesting six rate cuts in 2024, the count went up to seven, but has now declined to two. Some observers are calling for no rate cuts. Our current view is that there will be enough economic weakness for the Fed to cut in September and December.

4
?**Credit spreads widen as interest rates decline.**

As a reminder, credit spreads (both corporate and high yield) declined noticeably in November and December, coincident with the implicit Fed pivot language. The narrowing has continued into 2024, albeit at a slower pace. With spreads historically tight, our “economy weakens” thesis suggests a re-widening of credit spreads for the balance of the year.

5
?**Earnings growth falls short of the double-digit percentage consensus expectation.**

Double-digit earnings growth is the consensus for both this year and 2025. (Reminder: Long-term earnings growth in the U.S. is 6-7%.) The optimism around earnings growth stems from the soft or no landing consensus view for the economy, as well as a belief that profit margins can widen from current levels. Granted, Q1 earnings were strong, but we remain cautious on the probability of double-digit earnings growth for the full year.

6
?**Stocks record a new all-time high early in the year, but then experience a fade.**

Stocks have certainly climbed to new all-time highs multiple times so far this year. While the S&P 500 rose again in Q2 (+4%), the average stock fell (-3%). We expect choppiness to dominate the second half, and at some point, a noticeable pullback as either 1) earnings fall short of expectations or 2) multiples (currently 22x, i.e., top decile versus history) decline as interest rates and inflation remain stubborn. Historically, stocks have done reasonably well following the first Fed increase in a cycle, but not as well when rates start to be cut.

7
✓**Energy, financials and consumer staples outperform utilities, healthcare and real estate.**

Our sector prediction is heading in the right direction with energy (+9%), financials (+9%), consumer staples (+8%), utilities (+8%), healthcare (+7%), and real estate (-4%). We expect this differential to hold, if not expand, for the balance of the year.

8
✓**Faith-based share of industry AUM rises for the eighth year in a row.**

While we have only one quarter of positive data, it seems like more and more individuals, financial advisors, and institutions are attempting to align their and their clients' investments with their values. We will monitor this one carefully.

9
?**Geopolitical crosscurrents multiply but have little impact on markets.**

It seems as though there is a new geopolitical hot spot every few months. The world is an increasingly dangerous place. So far, these issues have not had a material impact on markets (e.g., the Middle East conflict has not significantly affected the price of oil, and therefore the markets have not been impacted.) We expect the geopolitical issues to continue to fester.

10
?**The White House, Senate and House all switch parties in November.**

Obviously, the outcome of this prediction will not be known until November. Indications are that the race for the White House and the House will be close; more and more pundits identify the Senate as the most likely place where the incumbent party is defeated.

Final Tally:

✓ 3

✗ 0

? 7

In summary (Written December 2023):

We expect a more challenging backdrop for stocks in 2024, with softening consumer spending at a time when investor sentiment has turned bullish. Equities are richly valued with volatility near historic lows, even as geopolitical and domestic political risks remain elevated. We expect the 2023 momentum and Fed cut euphoria to fade early in the new year, resulting in lackluster earnings growth with downside risk to equities as 2024 unfolds. At some point, the political dysfunction in Washington, D.C., and record non-recession, non-war deficits pile up even as interest expense takes an even larger share of governmental spending. As such, we believe markets are excessively focused on monetary policy and are almost ignoring fiscal policy.

A mixed quarter, depending on your perspective

On the surface, stocks did well in Q2 (S&P 500 +3.92%). But underneath the surface, the equal-weighted S&P 500 was down 3%. So, was it a good quarter or a bad quarter? The big story remained the awesome performance of the Mag 7 stocks driving the NASDAQ +8.26% (while the Russell 2000 fell 3.62%). Adding to the discussion was the fact that most bonds fell (10-year Treasury yields rose 18 bps). Technical weakness evidenced itself as the percentage of stocks trading above their 50-day moving average fell from 78% to 46% during the quarter. Perhaps the biggest story was the hawkish repricing of Fed rate cut expectations in the face of somewhat stubborn inflation and continued robust job growth. By the end of the quarter, increasing signs of economic weakness surfaced, with primary attention on the health of the U.S. consumer. The Citigroup Economic Surprise Index fell to its lowest level in nearly two years. First-quarter earnings growth was a better-than-expected 5.8%. Gold was up (+4.5%) for the third straight quarter and oil fell about 2% after the big first-quarter increase. Technology stocks (+13.61%) and communication services (+9.11%) led the way, with materials (-4.90%) and industrials (-3.26%) lagging.

Looking forward, the bull case remains focused on continuing disinflation, approaching (even if delayed) Fed rate cuts, ongoing AI optimism, and a strong belief in a soft landing. Bears worry about the health of the consumer leading to economic weakness, the potential for rising unemployment, disbelief about a further significant fall in inflation, expensive valuations, and narrowing breadth.

Investment backdrop

Equities continue to consolidate after previously hitting overbought levels. The stock market has managed to hit new highs lately but on thin leadership, while the average stock has tracked roughly sideways. Meanwhile, government bonds remain reasonably well bid with the hope of sustained central bank easing on the back of lower inflation.

The investment backdrop remains broadly supportive for equities, but performance will likely be choppy in the near term, given some signs of slowing growth in the U.S. economy yet generally improving conditions outside the U.S. While U.S. stocks have many positive attributes, in aggregate, historically rich absolute and relative valuations reflect overly exuberant growth expectations. A broadening of global growth momentum over the next six to 12 months should favor select non-U.S. equity markets that offer positive cyclical earnings beta and better valuations than the expensive U.S. market.

Is the economy weakening?

A world in which the Fed is “data dependent” means that investors are highly prone to being whipsawed by economic data releases. While some of the macro data released in June was positive, several warning signs were also present, including new indications of U.S. consumer weakness.

U.S. consumers claim to be highly uncertain and/or bearish on the future. They also are far less upbeat on the economy’s overall prognosis than for their own situation. Conditions for U.S. households and consumption are indeed less favorable than during the pandemic rebound phase in terms of labor demand and the ability to extract much higher wages, as well as the mountain of excess savings built up during the pandemic. All of these drivers have weakened. At some point, U.S. corporate profits will weaken to the point where hiring will dry up and layoffs will mount in a meaningful fashion. Those conditions do not currently exist, but need to be watched carefully.

The Fed and inflation

While the free-money era is over, there is still a massive pool of existing investable funds. Consequently, asset inflation is still alive and well, consistent with monetary conditions not being restrictive. The backdrop of strong corporate earnings at a time of fairly stable bond yields is pro-growth and supportive of risk-taking. Any central bank rate cuts will provide an additional boost to an already improving global economic expansion. Keep in mind, rate cuts are mostly being driven by hopes for a return to the low inflation backdrop of the 2010s, and not because the global economy is threatening to slide into recession.

Inflation is now well below the peak readings of the cycle that occurred when prices spiked as the economy reopened and supply shortages were rampant in the face of a surge in demand. However, the unwinding of these distortions has now largely played out. Underlying inflation is still well above levels recorded last decade—and is proving sticky. Our view remains that U.S. inflation will settle at or about 3%. Although such readings are well below the peak readings of the current cycle, they are also well above the average of recent decades and are above current Fed and bond market expectations.

The Fed funds rate has reached previously recessionary levels when compared with median actual or potential GDP growth, as have market interest rates for the household and corporate sectors. C&I lending standards are tight and have not improved as much as corporate bond spreads suggested. C&I loan demand is not improving. Delinquency rates are rising from admittedly low levels.

The road ahead

It is likely that growth is now becoming more important to the Fed than inflation, with macro data broadly coming in softer, and many lower quality and economically sensitive areas of the market lagging while a narrow list of higher quality mega caps have carried performance. In our view, this is a sign the market is becoming more focused on growth softening and less focused on inflation and rates. The underperformance of small caps despite falling rates is a good example of this phenomenon.

U.S. growth has indeed slowed some, but this follows three quarters of particularly strong final demand growth from mid-2023. This, combined with sticky inflation, may end hopes of a sustained Fed rate-cutting cycle. There has been some turbulence in the highest-flying U.S. AI/tech plays, although the setback so far has been minor relative to prior gains. There has been considerable speculative behavior

of late, albeit focused on a narrow list of stocks. Still, most sectors have been able to grind higher or at least consolidate. The focus of attention has been on the perceived noncyclical, rapid growth tech and related sectors. As confidence in the non-U.S. economic prospects improves, we expect investors to belatedly and slowly broaden their range of preferred bets to the benefit of select non-U.S. equity markets and even some lagging U.S. equity sectors.

This year will witness many important elections that could have a meaningful impact on the business and investment cycles. As we write, France is about to have the first round of its election and the UK votes on July 4. The election with the greatest potential to be disruptive is in the U.S. this November. The outcome could prove important for investors in both the near term and over the long haul, but it is too soon to make any bets, especially as it relates to one-party control or a divided government.

Will federal debt levels matter?

One of the elephants in the room is the accelerating accumulation of federal debt, and the even faster rise in interest expense. The politics of the election season are ignoring this growing problem. Deficits don't matter until the bond market decides they do. If the bond vigilantes come out of the shadows and shun U.S. Treasuries, the outcome will be a rise in yields, a decline in equity prices, and a fall in the dollar. The Fed will likely respond with an easing in policy, but its room for maneuver may be constrained by the trend in the dollar.

Incurring debt is a way to bring spending from the future into the present. If the debt is used for productive purposes, then it can be self-financing because a resulting improvement in growth and cash flow allows the debt to be serviced and eventually repaid. If the debt is used to finance consumption, then it is more of a problem. Unfortunately, the rise in government debt is more related to consumption than investment, so it will likely end badly. The CBO's projections suggest that the sum of federal nondiscretionary spending and interest costs will soon exceed total revenues, and the gap will continue to increase. That is an unsustainable state of affairs.

Conclusion

Investors have been lulled into a false sense of security concerning the resiliency of the U.S. economy. Investors believe that the economy is in a steady state if nothing changes. However, our assessment that the monetary policy stance is tight means that something must change for a recession to be avoided. The U.S. avoided a recession in 2023 due to the deployment of excess household savings and a strong contribution to growth from fiscal spending. Fiscal thrust is set to be negative this year, and multiple measures of excess savings now point to their exhaustion. Forward-looking indicators of the U.S. labor market are no longer pointing to significant excess labor demand, which, along with rising consumer loan delinquencies, supports the view that excess savings have been spent. Business loan lending standards remain tight, and aggregate U.S. credit growth remains weak. Inflation will likely remain in a downtrend, but a return to target levels is unlikely. At some point, stocks are likely to run into difficulty when earnings estimates come under pressure.

Final observations

1. The U.S. economy appears to be slowing with more deceleration to come.
2. Inflation remains sticky; it will fall in an economic slowdown/recession but not achieve the Fed's 2% target.
3. The Fed is likely to cut in September or December (if our read of the economic tea leaves is accurate).
4. The magnitude of earnings beats is likely to decline as forecasts set a high bar for earnings growth.
5. An expensive stock market requires near perfection to continue to rise.
6. The stock market continues to narrow (2Q S&P 500 +4%, average S&P 500 stock -3%).
7. Non-U.S. economies (and stock markets) are slowly improving.
8. On a long-term basis, the dollar is overvalued and is likely to fall.
9. Federal interest expense is rising at an alarming pace.
10. U.S. election dynamics will matter.

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