Either/Or: A Pivotal '24

Late-cycle conditions persist, and we see paths for either slowing growth or a "soft landing" in 2024. We expect sectors with stable earnings growth to drive positive-but-volatile equity markets, while the interest rate backdrop should benefit fixed income.

SUMMARY

- We see paths for either a deterioration of economic growth with increased risk of recession or a "soft landing" in the U.S. in 2024, but we do not see fuel for a sustained reacceleration of growth.
- Investors are likely to favor U.S. equity sectors that offer relatively stable earnings growth this year, in our view, while more cyclical U.S. sectors and most international markets face greater risks.
- We see elevated yields and a potential decline in interest rates offering an attractive risk/return profile for fixed income.

Q4 AND 2023 REVIEW

The fourth quarter capped off a strong 2023 for equities, especially in the U.S. Yet, while the S&P 500 returned over 26% in 2023, gains were concentrated in mid-phase sectors, with a few large, tech-related names contributing the bulk of returns. Many other categories of U.S. stocks, including early-phase cyclical sectors, late-phase defensive sectors, value stocks, and small caps materially underperformed.

At the start of 2023, we anticipated slowing economic growth with an elevated risk of recession, but temporary factors helped extend the U.S. economic cycle into 2024. Real U.S. GDP growth slowed in the first half of 2023, but a sharp inventory build, government spending, and a residential construction rebound gave a likely temporary boost to growth in Q3. Meanwhile, various developments that risked economic contagion, including a spate of bank failures and retailer bankruptcies, were contained with minimal impact to the economy or markets.

The Fed initially continued to hike the Fed Funds rate amid elevated inflation readings and continued economic growth, before pausing in Q3 and ultimately signaling likely rate cuts in 2024. Volatility in longer-term interest rates weighed on bond prices for much of the year, but a rate pullback late in the year muted that impact.

International stocks underperformed the U.S. across most regions in 2023. Europe and emerging markets, most notably China, struggled with ongoing economic challenges.

OUTLOOK

Slowdown or Extension?
We see headwinds to economic growth, but also a realistic path to a "soft landing" in 2024.

Overview: We see a potential fork in the road for the economy in 2024. We still see late-cycle conditions globally, with key factors that have supported growth in recent quarters fading and more challenges for the U.S. consumer ahead, which all raises the risk of recession. However, we also see a realistic path toward a "soft landing" that could further extend the cycle. A shift to less restrictive monetary policy could help limit the negative impacts of the Fed's sharp rate-hiking cycle, but we believe it is very unlikely to kick off a new period of rapid economic expansion.

Absent an unexpected reacceleration of inflation, we also see potential for a continued pullback in Treasury yields in 2024. Still, interest rates should remain a headwind to growth, and credit spreads could widen.

The international picture remains challenged by economic headwinds in Europe and emerging markets, though we see a relatively attractive backdrop for developed Asia. Given the fragility we see in many international economies, we expect the ultimate direction of the U.S. economy in 2024 will be a key driver for economic health abroad.

U.S.: Economic drivers are in the process of rebalancing toward more typical late-cycle conditions, in our view. Temporary post-COVID factors that have helped sustain economic growth are fading, including record demand for labor, rebounding labor market participation, and above-trend consumer savings and wage growth. Meanwhile, after the sharpest set of rate hikes in half a century, the Fed is signaling a willingness to take its foot off the brakes, as is typical late in the cycle.

While strong demand for labor has been met with a robust return of participants to the workforce, the labor force participation rate is now essentially in line with pre-COVID levels, leaving less potential for labor force expansion to boost future growth. At the same time, the number of job openings, while still above 2019 levels, has fallen by more than 25% since peaking in early 2022. In addition, we continue to see outright payroll declines in several categories that tend to lead the broader labor market, and data from ADP suggest recent job growth has come mostly from small-to-medium size firms where the outlook is more uncertain, in our view, than for larger, well-resourced employers.

Along with job and income growth, recent drivers of consumption have included pandemic-era excess savings and a decline in the personal savings rate. Our analysis suggests consumers have effectively spent down their savings cushion, and the personal savings rate is now at lows not seen outside this cycle or the Great Financial Crisis era. Further, the three-year suspension of student debt payments, which likely fostered incremental consumption, ended in September 2023. As these extraordinary factors end, we expect consumption growth to re-align with decelerating labor market and income growth in 2024.

The industrial economy is also facing the loss of temporary growth drivers, and we expect fixed investment growth to slow in 2024. Fiscal stimulus helped boost fixed investment in 2023 in areas like semiconductor manufacturing, but the initial growth impact from prior stimulus measures has largely played out, and the potential for new incremental stimulus is limited, in our view. The rebound from COVID-era lows in transportation equipment investment also seems largely complete, removing another temporary tailwind for growth.

Late-Cycle Earnings Growth
S&P 500 earnings growth is expected to be driven by mid-phase and late-phase sectors in 2024.

The equity earnings outlook also suggests late-cycle conditions, in our view. While S&P 500 earnings per share growth is expected to rebound from essentially flat in 2023 to nearly 12% in 2024, that growth primarily comes from mid-phase and late-phase sectors, such as Information Technology and Health Care. Early-phase sectors like Financials and Industrials are expected to deliver only a fraction of the earnings growth they would typically see at the start of a new cycle.

On the positive side, the Fed's more dovish tone in December clearly boosted market sentiment. However, even if the Fed cuts rates by the 150+ basis points that futures markets now seem to be pricing in for 2024, short-term interest rates would still be high relative to the past quarter-century and well above the expected trajectory of CPI. The Fed is also continuing quantitative tightening efforts (reducing longer-term bond holdings), so overall monetary policy remains far from accommodative. Absent evidence of significant economic weakness, we expect the Fed to continue talking down expectations for substantial cuts. Still, the Fed's tone shifted earlier than we expected, which could help soften the future impacts of its sharp tightening.

Overall, we see a U.S. economic backdrop that could move toward a slowdown or a "soft landing" in 2024. Our current positioning in U.S. equity allocations reflects a balance of mid-phase and late-phase sector exposures that we expect should do well in either scenario. We do anticipate periods of equity market volatility in 2024, amid speculation over Fed policy, macroeconomic cross currents, and election noise. We believe earnings growth should support positive equity returns, overall, in the U.S., though we see little prospect of sustained valuation multiple expansion in an environment of moderate or slowing economic growth, policy uncertainty, and market volatility.

International: Foreign economies face many of the same economic headwinds as the U.S., but some key differences reduce our international outlook. For example, in emerging markets, China's growth remains anemic due to negative wealth effects and deleveraging. We expect its growth to be muted in 2024, given weak export demand, its property sector downturn, and limited stimulus.

European growth remains sluggish and is likely to trail U.S. growth in 2024, in our view. Europe is facing a pullback in household consumption and investment, along with higher inflation risks and less of a savings cushion than the U.S. The ECB could ease in 2024, but we believe this would be a response to economic weakness rather than simply a move to normalize policy. Further, with roughly half of European equity market capitalization in early-phase, economically sensitive sectors like Financials, Industrials, and Energy, we believe European earnings growth will be below the U.S. and Japan in 2024.

Our one current international overweight in global portfolios is developed Asia. Economic output remains below potential in Japan, while stimulative monetary and fiscal policies remain in place. Further, Japanese inflation is starting to recede, offering a potential boost for real domestic consumption, while nominal GDP appears to be on a favorable trajectory to benefit Japanese earnings growth this year.

Fixed income and other assets: For balanced portfolios, we believe elevated yields on fixed income, combined with possible appreciation if interest rates should fall, presents a compelling return potential for intermediate and longer-term bonds. We believe the risk of sustained upside to longer-term interest rates is limited, and that the key driver in the first half of 2024 is likely to be short-term policy rate expectations. However, corporate credit spreads are unusually low and could widen in 2024, tied to negative economic surprises and heavy issuance.

Given this outlook, we are overweight fixed income in traditional balanced strategies and, within fixed income, have increased Treasury bond exposure, which has typically outperformed corporate bonds during periods of economic weakness, often posting positive overall returns. We continue to emphasize longer-term securities which could benefit from falling rates as economic activity slows.

In portfolios with latitude to include real asset allocations, we see diversification and appreciation potential from exposure to gold, given continued investor uncertainty on the pace of global economic growth.

CONCLUSION

As impacts and echoes of the COVID-19 era continue to fade, we see the U.S. and global economies rebalancing into a more normal late-cycle environment. Given the current range of risks as well as pockets of continued economic strength, we see an economic slowdown as likely, but we also see a path to a "soft landing." Crucially, neither outcome entails a sustained near-term reacceleration of growth or a new economic cycle, and we have positioned portfolios accordingly. As always, we continue to evaluate the macroeconomic and market backdrop, and we will actively adjust portfolios as our outlook evolves.

WestEnd Advisors Investment Team | January 2, 2024

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