Cetera® Investment Management LLC

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2024 Annual Outlook

The Fed: From Foe to Friend

In 2023, it appears we avoided what many prognosticators called "the most anticipated recession in history." But recession risks entering 2024 haven't disappeared. GDP growth is expected to be low the first half of the year, leaving less room for error. It will be interesting to see how the economy continues to respond to higher interest rates and higher borrowing costs.

Typically, there is a lag of nine to twelve months before the economy fully feels the impact of the Fed's monetary policy. Perhaps the lag has been extended this time because the Fed was late raising interest rates and borrowers got out in front of the Fed by refinancing homes and long-term leases before the Fed was able to do their work.

Many believe the Fed can navigate this interest-rate-hiking cycle without a recession, which historically is a feat it rarely achieves.

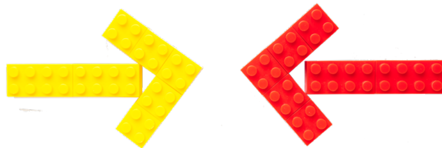
At-A-Glance

The U.S. economy has been resilient in 2023, defying a widely expected recession.

Economic growth at the start of 2024 is expected to be weak, so the possibility of a recession is still elevated.

There are **increased geopolitical risks** in Europe, Asia, and the Middle East. Combined with a presidential election year, there will be a lot of negative headlines for investors to digest.

Inflation expectations for 2024 are encouraging. Currently, many forecasts, including the Fed's, are for roughly 2.5%, which is not far from the Fed's 2% long-term target. The Fed could get comfortable enough to cut rates.



Volatility, which eased in 2023, could be elevated, especially if the Fed is reluctant to cut interest rates in the face of weak growth or falling inflation. The risk of a Fed policy error is high.

Volatility could favor bonds and asset classes that have been out of favor in recent years. **Diversification is prudent.**

Earnings growth is expected to be better in 2024, which should help support equity markets. Breadth was weak in 2023, but performance could broaden beyond growth sectors in 2024.

The good news is that the economy is indeed bouncing back from its lows in many areas, and despite some slight weakening, the labor market remains healthy. This could make for a mild recession—if that recession even appears. Possibly the best news would be that the Fed would likely reverse course and cut rates, which would alleviate the "higher for longer" fears that the Fed has been instilling in markets.

With volatility can come opportunity. Large cap and especially large cap growth stocks are trading at valuations much higher than their historical averages. Either earnings will have to catch up, stock prices will retreat, or maybe we'll end up with a little of both. Beyond large cap, valuations are much better. Mid cap, small cap, value, international, and emerging markets all have better relative valuations when looking at history. Being diversified has not been a benefit in recent years as momentum in these large cap growth stocks has been strong. Much like the 1990s, diversification didn't help...until it did in the 2000s. We believe 2024 will be the year other asset classes get their chance to shine.

Bonds continued to struggle for most of the year, but 2024 could shape up to be a good year for bonds too. Inflation expectations are falling, which should provide downward pressure on yields, especially if there is weak economic growth. When yields fall, bond prices rise. Plus, bonds are paying yields we haven't seen in decades, even outpacing the rate of inflation, making inflation-adjusted bond yields positive.

Your Cetera financial professional can help you through the uncertainty of the next year to keep you focused on your personal goals and objectives. There will be added distractions thanks to it being an election year, but focusing on your own goals and objectives will help take the emotion out of investing. And if things get a little bumpy, remember that volatility can also create opportunity.

Global Economy

The Recession that Never Was?

Looking back at 2023, it looks as though "the most anticipated recession ever" as it was dubbed by the financial media won't come to fruition in 2023 after all. With some key leading indicators flashing red, we thought the risk of recession was elevated, but that any resultant recession would likely be mild. Unlike during the Financial Crisis, consumer balance sheets are strong.

Additionally, the labor market was starting from a point of strength with very low unemployment and a supply-and-demand imbalance that favored workers. The year started with over five million more job openings than unemployed individuals. As the United States is a consumer-driven economy, this is good news: if people have jobs and are not scared of losing them, they tend to spend money.

Inflation was also expected to ease and there was a high probability that the Fed would stop raising interest rates or even cut them.

Ultimately, the Fed was tougher than many anticipated, but it appears it's stopped raising interest rates, and cuts may be in the cards for 2024 instead.

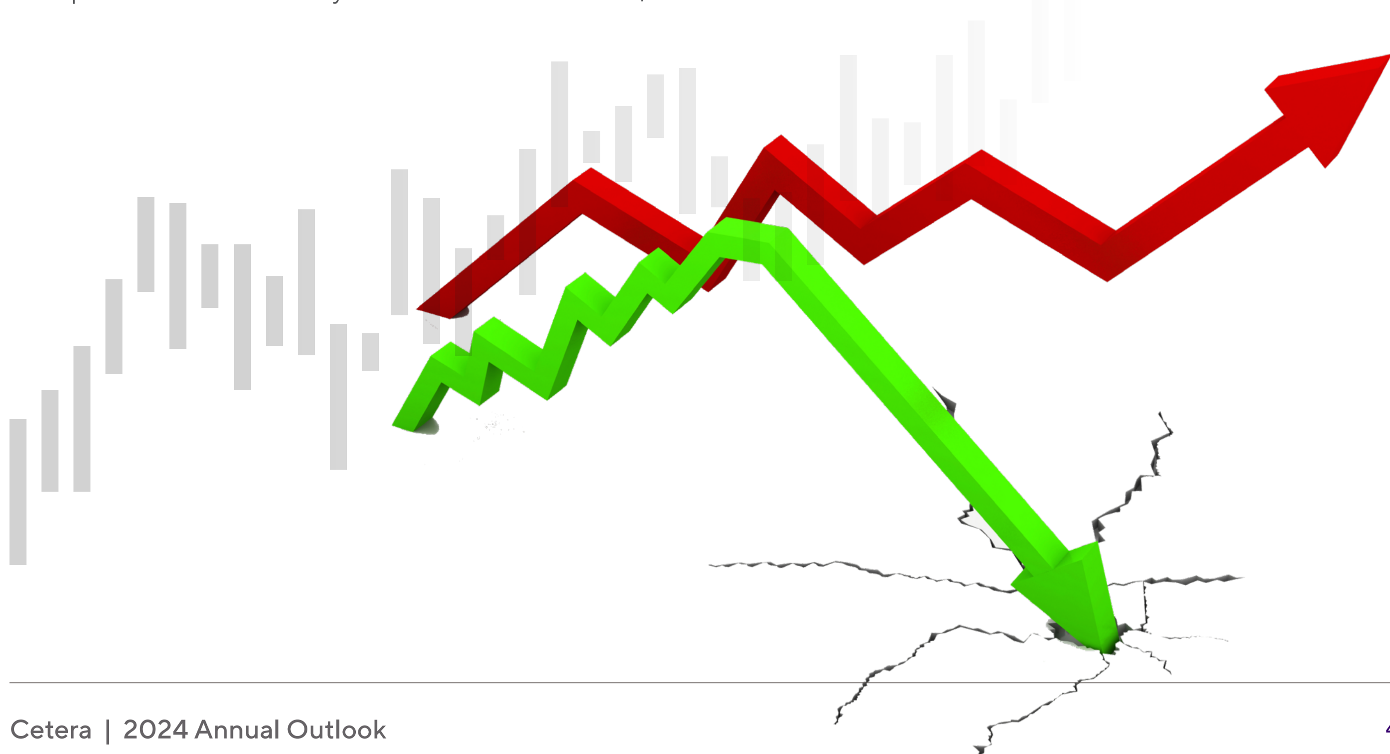
Expectations were low for the economy heading into 2023, so we thought there would be a lot of positive economic surprises to look forward to in the second half of the year. As it turns out, the economy exceeded expectations for almost the entire year, as first and second quarter gross domestic product (GDP) growth topped 2%, and the third quarter well exceeded the first two quarters with growth just north of 5%. The economy was resilient, growing despite the Federal Reserve's restrictive policies and a high inflationary environment. But timing recessions is difficult, so before we declare victory on inflation and a soft economic landing, we'll consider what's on the horizon for next year and address some longer-term themes.

Recession Risk Remains Elevated

While it appears we'll avoid a recession in 2023, the risk of recession is still high entering 2024. Capital Economics, a research firm based in London, estimates the U.S. GDP growth rate will be 0.8% in 2024. With such a low growth rate, the room for error is low. For the reasons mentioned above, we still think any potential recession could be mild. Recessions are a normal part of the economic cycle, and most are not severe like the Financial Crisis still etched into our minds.

Not only are recessions difficult to predict and time, but economic data is backward looking. You may not know you are in a recession until you are out of the recession, and even then, you may not know you are out of the recession. Add to that the fact that stock and bond markets are forward looking, so it is possible to get positive stock returns in a recession as investors look to the future. The end—and often confusing—result is that stocks typically decline ahead of a recession and bottom before a recession ends. The key point to remember is that positioning your portfolio around recession risks can be difficult.

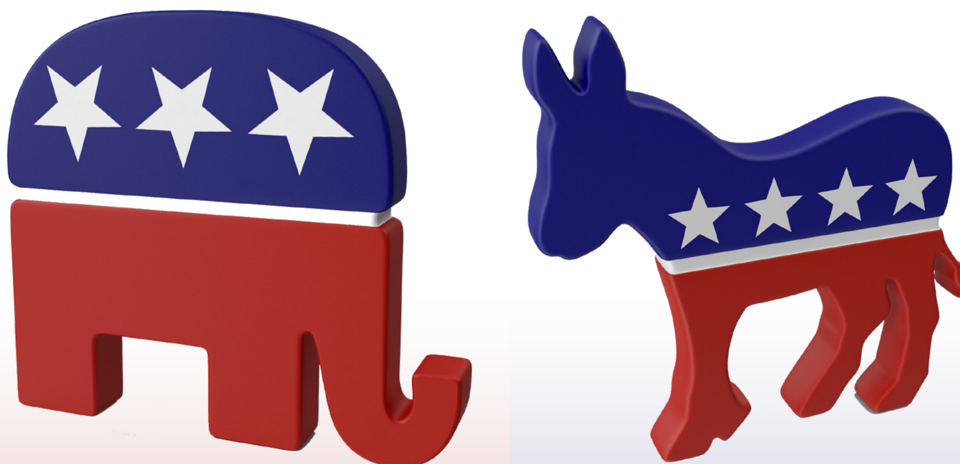
Recession risk is currently elevated because some leading economic indicators are pointing toward weakness. There is negative temporary help employment growth, weak real retail sales growth (though improving), an inverted Treasury yield curve, and the Leading Economic Index has declined at a magnitude that historically has been associated with a recession. (We publish these figures in our quarterly Chartbook, so you can follow along during the year to see how they change from quarter to quarter.) The good news is that all but temporary help employment is trending up from their lows. As expectations are currently for a weaker start to 2024, there is elevated risk for an economic decline.



Apart from these leading indicators, there are other risks to economic growth. Many fear the impact the resumption of student loan payments will have on the economy, although this will likely have little effect on economic growth. Higher bond yields, however, will continue to be an economic drag, causing lending to remain weak since companies and individuals can't afford borrowing at these higher rates. Personal savings are also down as consumers need to spend more to keep pace with inflation.

With a high federal budget deficit, more stimulus is already unlikely, and with 2024 being an election year, it's even more improbable as politicians position themselves one way or another to win primary elections. Political compromises will be hard to come by. And with less agreement, we could also see a government shutdown if lawmakers can't agree on a spending bill. Shutdowns typically don't have long-term impacts to economic growth, but they could delay it and push growth from one quarter into another. The first half of 2024 is already expected to be weak. A shutdown could also add to volatility in markets. However, investing based on politics tends to be a losing proposition, and while this election cycle will no doubt be heated, the economy and markets are influenced more by factors beyond domestic politics.

One such potential headwind for the economy is geopolitical risk, like the uncertainties around the wars in the Middle East and Ukraine, which might escalate, or new conflicts could arise elsewhere. Such hostilities are hard to predict and can turn markets quickly. Add to that another looming risk related to the Fed, which has been talking tough for a long time and has largely stayed true to their word. They were late to raise interest rates and were forced to raise them very quickly without a more measured rollout that would allow them to gauge the impact on the economy. So far, they seem to have sidestepped this risk—but if the economy starts to show signs of cracking from the culmination of all the rate hikes, will they take swifter action and cut rates soon enough?



The Fed: From Foe to Friend?

If a recession materializes in 2024, the Fed could go from foe to friend. The Fed has been a headwind for the economy for some time, raising interest rates to try to slow economic growth and the labor market in hopes of taming inflation. And while it does seem under control now, inflation is still higher than the Fed would like. Should there be a recession, inflation would likely retreat even more and give the Fed the ability to cut rates to stimulate economic growth and minimize damage to the labor market.

The CME FedWatch Tool, which uses futures markets to measure implied probabilities, currently shows interest rate traders are predicting that the Fed Funds rate could be more than 0.75% lower by the end of 2024. Looking at the Fed's own predictions in their September dot plot, Fed members have a median projection that the Fed Funds rate will be 0.25% lower than it is today.

The risk here is that the Fed keeps rates higher for too long and causes damage to the labor market and the economy. However, if we use past recessions as a guide, the rate cuts could be even more dramatic if we do finally get this long-awaited recession. If the Fed surprises markets by cutting rates more than expected, this could make the Fed a friend to markets once again.

Global Divergence

Economies that were in sync with one another during the pandemic are starting to diverge and this is creating differences in central bank actions. Even if the U.S. avoids a recession, a global recession could be a drag on the U.S. Europe will continue to be hampered by expensive energy with the lack of Russian oil and gas. The Eurozone GDP is expected to be zero next year. Meanwhile, the Chinese central bank is already starting to cut rates as they attempt to stimulate the slowing economy.

Overall, the global economy is expected to slow in 2024. The silver lining is that these divergences could create more opportunities for investors looking for diversification, which we will discuss more in the equity section. With slowing growth rates, global inflation is also expected to slow.

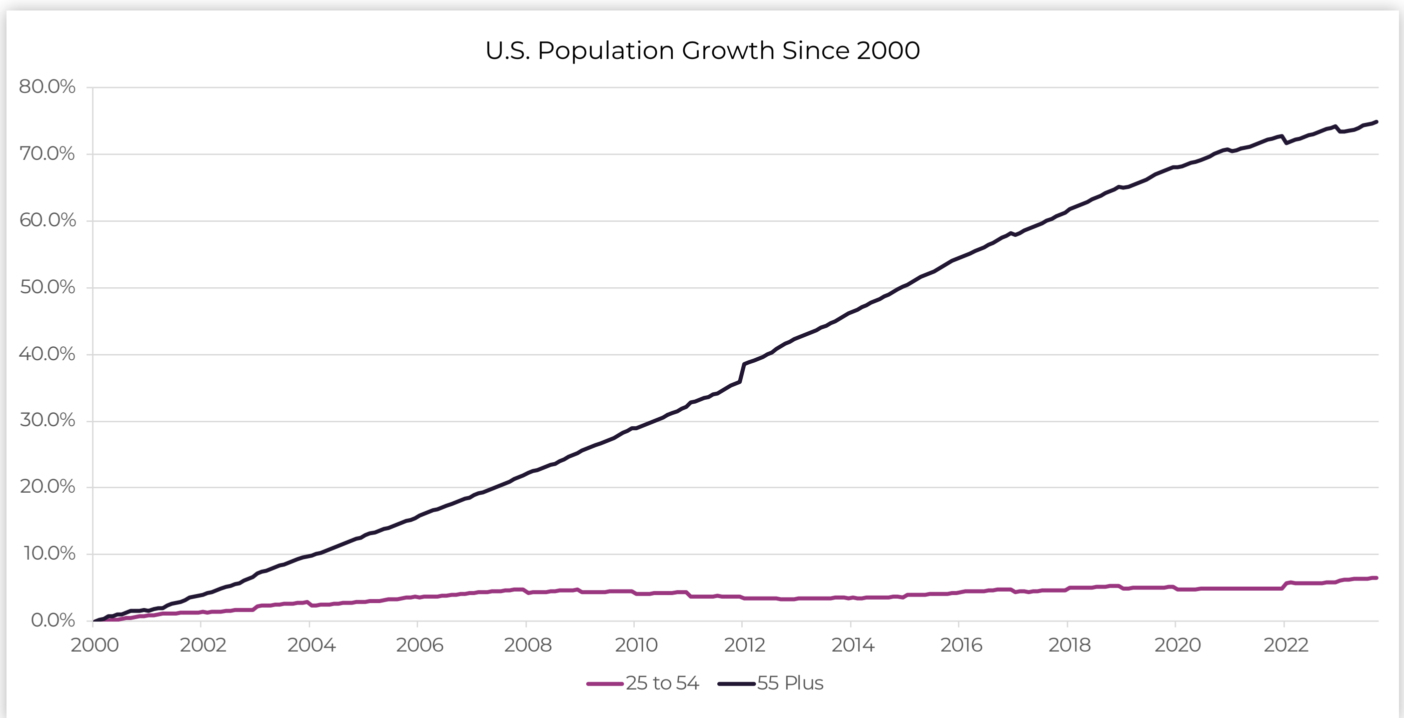
The Roaring 20s?

In our Outlooks we typically write about what we expect in the coming quarter or year, but investing is typically done with a longer horizon in mind. The stage is currently being set for long-term growth—growth we may not see in the next couple of years, but for which we can watch certain themes develop. Timing these developments can be difficult as there can be setbacks along the way. And sometimes they develop so slowly you don't necessarily notice them until it is too late.

As their generation's name implies, there was a surge in population growth when the baby boomers were born. But since then, population growth has slowed. The baby boomers are hitting retirement at an increasing rate. From January 2000 to September 2023 the population of people over 55 years old increased by 75%, or 42.8 million (Figure 1). Over that same period the population of 25–54-year-olds (prime-age workforce) only increased by 6.5%, or 7.8 million.

This has many implications, especially for the labor market. With help wanted signs seemingly everywhere and more job openings than people looking for work, one might question where all the workers went. In part, they retired. This disparity creates a problem that won't go away anytime soon, and slowing population growth is bad news for economic growth. This is not just a problem for the U.S., but for most developed countries. The good news is that with challenges come opportunities.

Figure 1: Aging Population



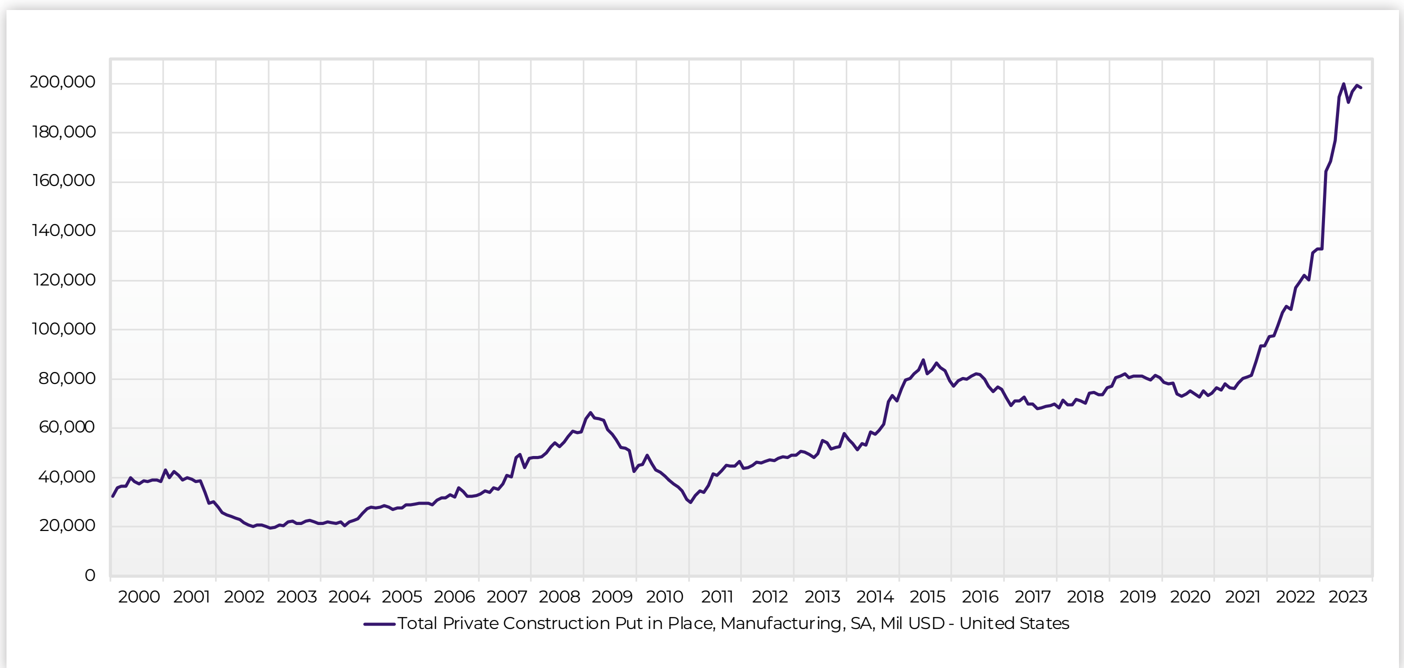
Source: Cetera Investment Management, Federal Reserve Bank of St. Louis, U.S. Bureau of Labor Statistics. Data as of 9/30/2023.

In August of 2022, Congress passed the CHIPS and Science Act which provided roughly $280 billion in new funding to boost domestic research and manufacturing of semiconductors in the United States. The race for artificial intelligence to boost productivity to help solve the world's aging population problem has already begun. We have seen a lot of optimism around this in stock markets—but it may be a little premature. This is a long-term theme that will take time to play out. Optimism will peak and fade as it did in the early 2000s with all the potential predicted to follow in the internet's wake. Similarly, AI will come to fruition, but it may take years to fully see those higher productivity benefits and ensuing potential higher economic growth rates.

The aging population could also serve to lower long-term bond yields as this demographic shifts from stocks to bonds for stable income and safety. Lower bond yields are a catalyst for growth, not to mention good for bond prices and thus bond returns.

The U.S. may also be able to capitalize on cheaper energy prices and its ability to be energy independent with its abundance of cheap natural gas. With energy prices in Europe rising, it's cheaper to manufacture in the U.S., which also carries the benefit of its large customer base and resultant reduced costs, as having manufacturing closer to potential customers saves on transportation. With the world more conscious about carbon emissions, it could be advantageous to manufacture goods in North America. Add to that the fact that carbon emissions are a global problem, exporting pollution to other countries with lower emissions standards may eventually gain scrutiny. We are already seeing the groundwork for another domestic manufacturing boom, with construction spending on manufacturing facilities in the U.S. more than doubling since the start of 2022 (Figure 2).

Figure 2: Total Construction Spending on Manufacturing Facilities



Source: Cetera Investment Management, FactSet, U.S. Census Bureau. Data as of 9/30/2023.

Another long-term catalyst around an aging population might not even be that far into the future. Housing can drive economic growth not only through high leverage, as many people finance their home purchases, but also due to the additional effects of homeownership, such as buying appliances and furniture. There is a lot of pent-up demand for homes within the millennial age group. If mortgage rates fall, we could see the reemergence of a large economic growth driver that has been somewhat absent since the Financial Crisis. Multifamily construction (apartments) is starting to fade, and single-family homes are trending upward. A drop in rates could help housing roll out of a recession in home sales activity.

The economic outlook seems to be brightening, but there are lot of risks that remain, and a recession in the first half of the year wouldn't arrive unexpectedly. Should that happen, the Fed would likely cut rates, and in an environment of labor imbalances that have created low unemployment, we would likely experience a milder recession. Longer-term, there are some themes that could prove to be bullish. Artificial intelligence and onshoring manufacturing back to the United States could offset the lack of population growth, but we may only see hints of these themes in 2024, as they will play out on a longer time frame.

Equity Markets

In the Roaring Twenties that kicked off over a century ago, America saw a boom in stocks led in part by optimism around automation that revolutionized the world. The automation at that time was the wide-scale use of assembly lines and electricity in manufacturing production. While both technologies were invented many years before the 1920s, then as now, new technologies required infrastructure and adoption, so it wasn't really until the 1920s that these advances could come into their own.

Today we have the prospects of artificial intelligence that will eventually revolutionize the world. According to a report from consulting firm McKinsey & Company, AI could add the equivalent of $2.6 trillion to $4.4 trillion annually to global productivity. We have already seen optimism in stocks that provide the infrastructure for AI, such as chipmakers and data storage providers. These companies saw their stock prices rise well above their future projected earnings because the growth in their future earnings could be massive. However, this could lead us to another comparison: the 1990s.

With the advent of the internet, investors bid up stock prices of companies that could benefit from the new technology. However, the infrastructure wasn't really in place yet. Internet connections were slow, and it was hard to buy things online. Shipping costs were high, and many consumers still did not trust online retailers or even have internet access. Eventually, the stock prices of these companies fell as they were unable to meet the high expectations for their earnings growth.

In looking at price-to-earnings ratios, the divergence between growth and value stocks hasn't been this wide since 2002 (it was even higher before 2002). AI enthusiasm has driven up stock prices of some large growth companies that has propelled much of this disparity. Either these companies must produce earnings to match the high expectations placed on them or they will eventually come back down to earth. As we learned in the 1990s, these discrepancies in valuations can last for years, and timing them is difficult. Many lost money anticipating the burst of the dot-com bubble. In the end, they were correct—but their timing was wrong, and it cost them.

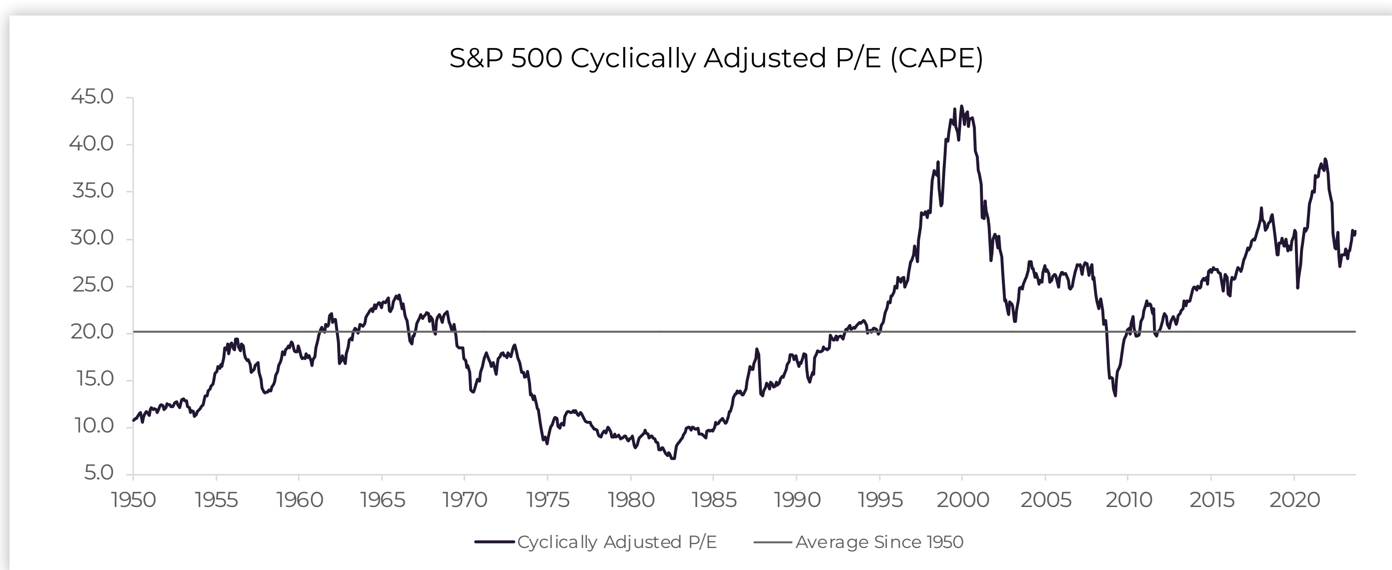
The question for these AI stocks now is whether they can generate the earnings investors are expecting before those investors lose faith. While the internet was revolutionary, it took a while for the infrastructure and adoption to fully take hold. E-commerce retail sales as a percent of total sales was 0.6% in the fourth quarter of 1999 and 10 years later in 2009 it was 4.1%. Today, it is over 15%. As with the internet, AI must benefit other non-AI companies for it to be widespread. The internet is used by small companies as well as low-growth companies, and it does not just benefit companies in the internet industry.

Adoption of AI will eventually benefit all companies by making them more efficient, but currently AI isn't being used in their everyday operations. Is AI similar to the dot-com bubble? Could investors be premature in their enthusiasm? Only time will tell, but in the meantime, we can still learn lessons from the 90s.

The price of stocks relative to their earnings in the 1990s skyrocketed. Growth stocks became much more expensive than value stocks and U.S. large-cap stocks became much more expensive than small-cap and international stocks. Today, we see a similar phenomenon. These dislocations can last for years, but for long-term investors not trying to time these dislocations, investing in value stocks, small-company stocks, and international stocks could see better entry points and opportunities in these areas of the market.

Since we are considering longer-term themes, let's look at longer-term valuation metrics. A key theme is the cyclically adjusted price-to-earnings ratio (CAPE ratio) otherwise known as the Shiller P/E ratio because it was popularized by renowned Yale University professor Robert Shiller. This ratio factors in that companies do better or worse during different parts of the economic cycle and looks to smooth those effects. It measures the share price relative to average earnings per share over a 10-year period adjusted for inflation. As you can see in **Figure 3,** the CAPE ratio is high relative to its long-term average. While the average since 1950 is 20.2, the ratio peaked in December of 1999 at 44.2. It was 30.8 as of September 2023. Based on this long-term ratio meant to account for earnings during different economic cycles, it appears that the S&P 500 is over-valued relative to its earnings. The high P/E for the index is driven mainly by the growing size of large growth companies in the index.

Figure 3: CAPE Ratio



Source: Cetera Investment Management, YCharts, Standard & Poor's. Data as of 9/30/2023.

While stock prices appear to be rich for large growth companies and there appears to be better value out there in other areas of the market, earnings are expected to improve. After three consecutive quarters of it being negative, earnings growth turned positive for the S&P 500 in the third quarter of 2023. Looking to 2024, earnings growth is expected to be near 12% according to FactSet. If inflation moderates more than expected, we could see even better earnings as input costs of companies decline.

If the most anticipated recession ever does occur, we could see another stock market correction, or even another bear market. A correction simply means stocks are down 10% from their high point, and a bear market is a 20% drawdown. We saw a bear market in 2022 and there was a correction in the third quarter of 2023 when the S&P 500 fell 10% off its July peak. Corrections are normal though. From 1980 to 2022, the S&P 500 had an average intra-year drawdown of 14.3%, yet the average annual total return was 12.9%. Corrections can also be an opportunity in that they potentially allow better entry points, where stocks can be purchased at a relative discount.

A recession could also cause stock market volatility, and companies would experience lower earnings than projected. This is a key example of why diversification is important. Owning more than just high-flying growth stocks and diversifying with other stocks that perhaps haven't done as well recently might be prudent. We also don't want to discourage owning growth stocks, but understanding your portfolio's concentration risks is important.

Another long-term theme is the strength of the U.S. dollar. The dollar has been strong because economic growth in the U.S. has outpaced much of the developed world, and interest rates are higher. A recession and subsequent interest rate cuts could cause the dollar to fall relative to other countries which are still fighting higher inflation. U.S. investors investing in international stocks would benefit from currency translation effects, essentially boosting returns from rising foreign currencies.

Overall, we think 2024 could be a good year for stocks though there will be bumps along the way.

Geopolitical events, election news, and a possible recession will stir angst among investors, and some longer-term themes may take more than a year to play out. Growth stocks could always continue their momentum in 2024, but now might be a good time to look at concentration risk and diversify into areas that may not have done as well recently. Companies that thrived in a low interest rate environment may struggle if interest rates stay high for a prolonged period. In higher interest rate periods investors tend to prefer companies that have proven cash flows and earnings rather than growth companies that promise earnings in the future. Investors should not get clouded by past returns and focus on what can do well going forward.

Economic cycles change and when they do, different companies benefit. While we looked at parallels in recent history, it's clear from the CAPE ratio that we are not at dot-com levels, and if earnings improve as is expected, these ratios will also continue to strengthen. History doesn't always repeat itself, but sometimes it rhymes. That's why we favor diversification and limiting concentration risk and are still optimistic about the future.

Fixed Income

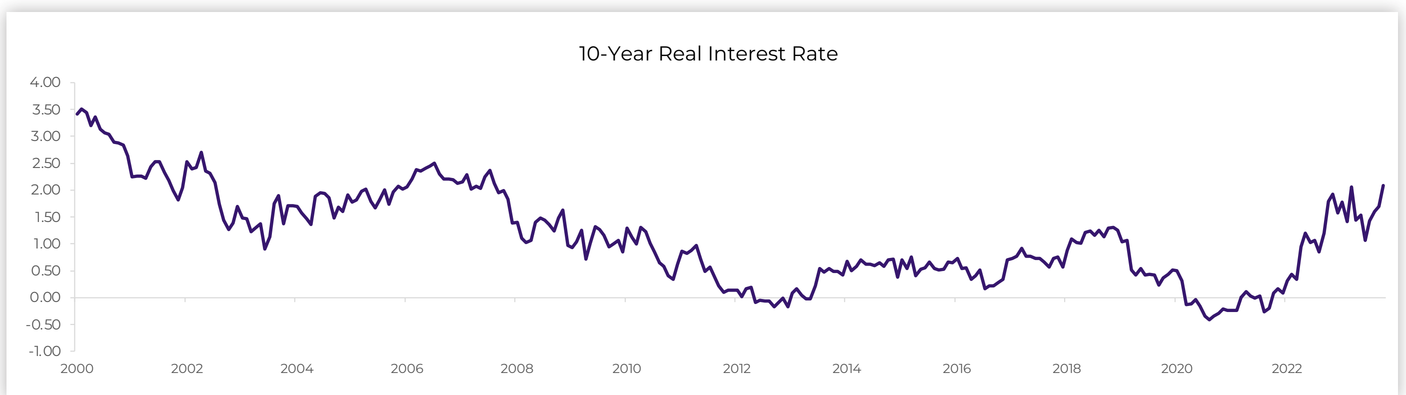
In October, 10-Year Treasury yields hit 5% for the first time since 2007. With bond prices moving in the opposite direction as bond yields, longer-term bonds such as 10-Year Treasuries saw their prices fall. The higher yields helped offset these losses, but bonds continued to struggle following their worst year on record in 2022.

Our outlook for the economy includes geopolitical risks, a possible recession, a more dovish Federal Reserve, and slower global growth. These could all be good for bonds, as in global turmoil, investors seek a safe place to put their money, which usually includes high-quality bonds. Slower inflation and slower economic growth can lead to lower yields and higher bond prices. And finally, a dovish Fed—one that either holds rates where they are or even cuts rates—can push bond prices higher.

Looking across a longer time horizon, low population growth can depress economic growth, which would be supportive of bond prices. The newly retired baby boomers will demand more income and thus more bonds, which will help constrain bond yields. With more than half of baby boomers over 65, this demographic shift is not only a headwind for bond yields in the future, but also in the present. A good example of the impact on bond yields from an aging population is Japan. Slow population growth and an aging population contributed to subdued government bond yields in Japan compared to most developed countries.

Bond yields have been volatile, but for the sake of simplicity assuming the 10-Year Treasury yield is 5%, that would mean an inflation adjusted return (known as a real return) of around 2.5%. This is the first year investors with 10-Year Treasury bonds have seen real returns over 2% since before the Great Financial Crisis. Returns haven't been over 2.5% in over 20 years **(Figure 4)**. Real yields were even negative for much of 2020 and 2021. So even if these higher yields persist, that could be good for bond investors if inflation projections are correct. And if bond yields fall with inflation and lower this real return, like we mentioned before, it's still good for bond holders because that means bonds will appreciate in price.

Figure 4: 10-Year Real Interest Rate



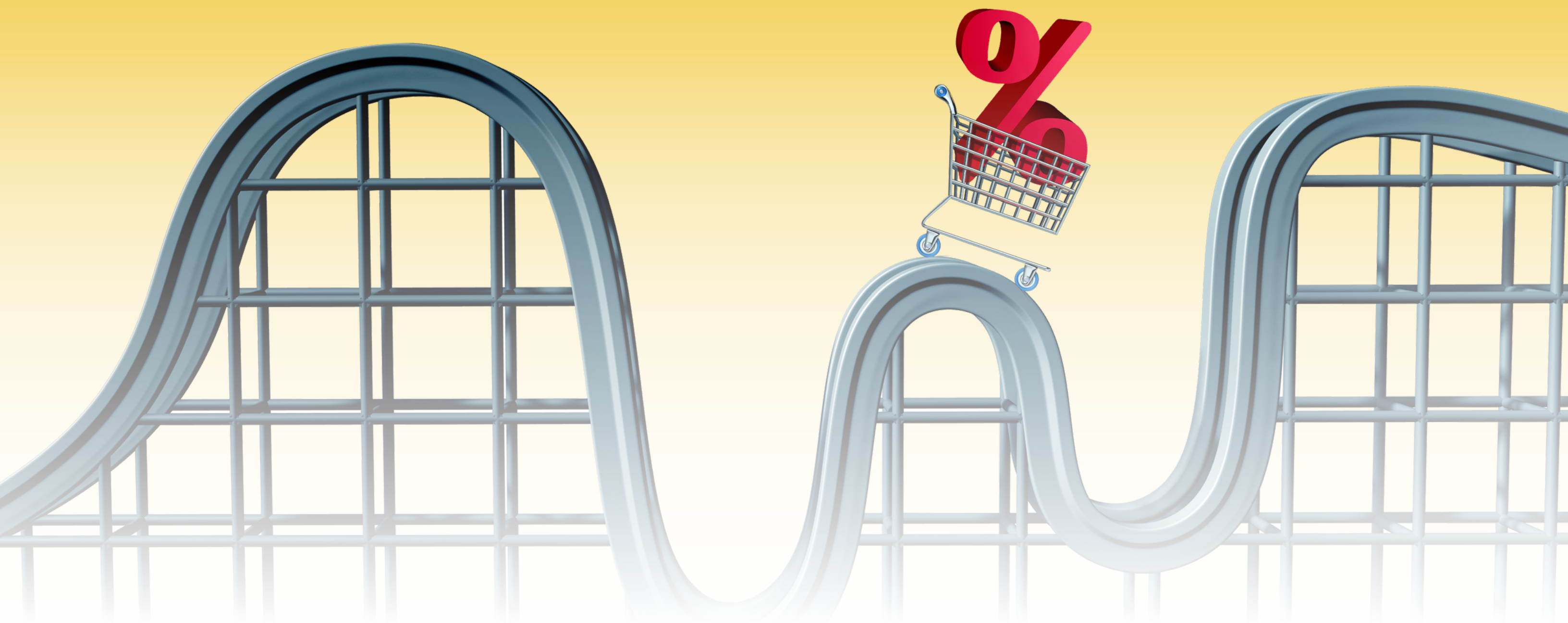
Source: Cetera Investment Management, Federal Reserve Bank of St. Louis, Federal Reserve Bank of Cleveland. Data as of 10/31/2023.

One common question for bond investors is where they should invest on the yield curve—2 years, 5 years, 10 years, or even 30 years to maturity? This is a complicated question because it depends on many factors including risk tolerances and investment objectives. With that in mind, the yield curve has been inverted for some time, with shorter-term bonds paying more than longer-term bonds. This can indicate that expectations are for lower future economic growth and inflation. It can also be viewed as a predictor of a future recession. If the Fed does cut rates next year, that will impact shorter-term bonds. Longer-term bonds are more influenced by the factors we already discussed. The 2-Year Treasury yield is even seen as a proxy of where the Fed Funds rate will be in a year from now, so if that holds true, one can expect rate cuts in the next 12 months because this yield is lower than the Fed Funds rate.

The higher yields in shorter-term bonds, which have less interest rate risk, seems counterintuitive. One should be compensated more for taking more risk. A lot of investors saw this as an opportunity to invest in short-term CDs and money markets and they have done well. Eventually, when the Fed cuts rates, these investors will not benefit as much. They will see their yields fall and the prices of their asset bases will remain the same. Opportunistic investors that are not typically invested in these short-term instruments may want to consider moving back to their longer-term asset allocations.

Moving away from government bonds, corporate bonds have higher yields to compensate for the possibility of downgrade or default. The higher the risk, the higher the yield, and such higher-yield corporate bonds could buffer more of the interest rate volatility if yields continue to move higher. If there is a recession, credit spreads would likely widen and these bonds would go down in value, but their higher yields would compensate for some of this price loss. Higher-yielding bonds, such as those below investment grade would be hit harder during a recession, and for this reason, we recommend limiting exposure to them. Having a small allocation can be good diversification, but understanding your level of exposure here is important.

In summary, bonds continued their struggles from the previous couple of years as yields moved to their highest levels in more than 15 years. The risk and return relationship in bonds that we have spoken about in previous commentaries continues to improve as bond investors gain more yield. Just like timing stocks, timing bonds is extremely difficult. We discussed factors that could lead to lower future yields, which would in turn mean better bond returns—possibly returns that bond investors haven't seen in decades. On a real return basis, bond yields are already at levels not seen since 2007, and we are optimistic about the bond market. Bonds are a great diversification for equity volatility and the uncertainty in the world. While we remain cautious on high-yield bonds, they can still have a place in well-diversified portfolios.



The Bottom Line

Risks remain in the economy and markets, but in many areas the economic data is improving off its lows. Inflation is moderating and expected to be around 2.5% next year, which should give room for the Fed to reverse its interest rate policies and cut rates. If the Fed cuts rates more than expected, it could serve as a tailwind to both bonds and stocks.

Diversification may come back into favor in 2024. Large cap growth stocks have carried the market for much of 2023, but other stocks may shine if earnings growth comes in as many anticipate next year. With bonds finally paying a real return (after adjusted for inflation), they could provide solid diversification for any equity volatility. Being an election year with a lot of geopolitical headwinds and a Fed possibly transitioning its monetary policy to be less restrictive, there will likely be volatility along the way.

No matter what 2024 has in store, your Cetera financial professional can help you through any uncertainty and help keep you focused on your personal goals and objectives.

For more insights and information from the team, follow @CeteraIM on X (formerly Twitter). Don't forget to check out new clips discussing what may move in the markets in The Week Ahead.

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A diversified portfolio does not assure a profit or protect against loss in a declining market.

Glossary

The S&P 500 is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

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