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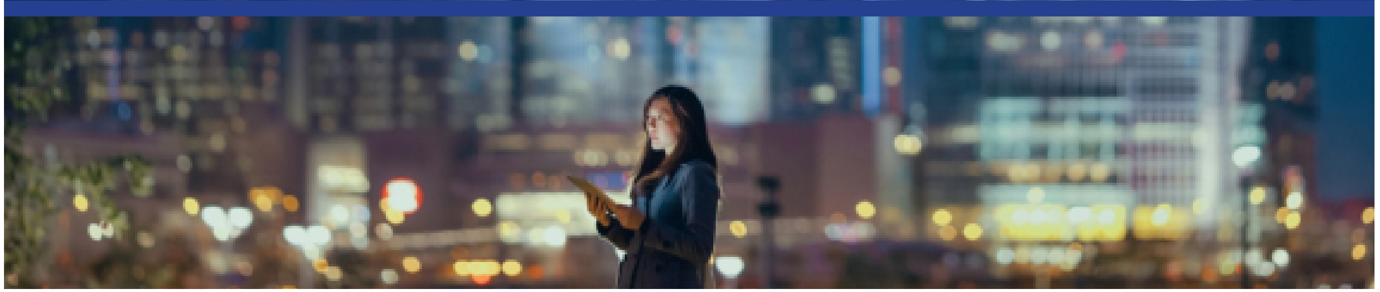

December 3, 2023

CIO Strategy Bulletin

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Wisdom for 2024: Answers to Your Questions

- **Will a recession in 2024 spoil the economy and markets?**
- **Will sticky inflation keep the Fed from cutting interest rates?**
- **How can corporate profits rise if the labor market slows in 2024?**
- **What's the right amount of cash to hold?**
- As we look ahead to 2024, investors maintain $5.8 trillion in money market funds[1]. Many believe that inflation has become a permanent problem and that the Fed will keep rates high, even if it means recession. In fact, a recession would be oddly useful as an "all clear" signal for investors to re-enter markets.
- 2023 has seen major short positions in equity markets and similarly big bets that interest rates will rise much further. Though these extreme views proved wrong, they were great sentiment indicators.
- But what if there is no typical recession or V-shaped recovery on the horizon?
- Expectations for a more normal economy are small. Yet, normalization is the story for 2024. That is why we have chosen these four questions from investors. The answers provide a baseline for reconsidering their assumptions and their predisposition to "wait for a better time to invest" than now.

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Q1: Will a recession in 2024 spoil the economy and markets?

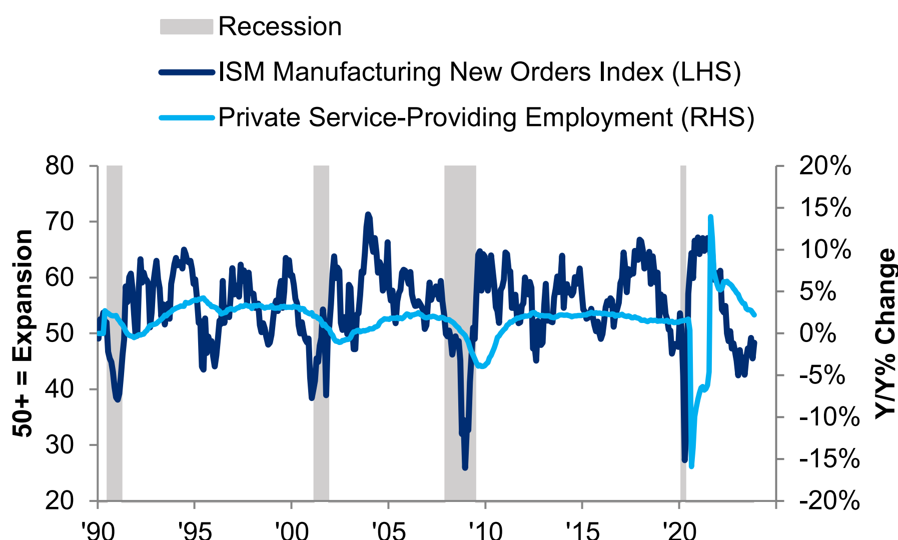
A: Despite a rapid and painful rise in interest rates and a significant tightening of financial conditions, we think a “standard US recession” in unlikely in ’24. In fact, we expect the US and world economy to slow in 2024 before strengthening substantially in 2025 (see last Quadrant and our soon-to-be-released Outlook 2024).

For 2024, we see employment growth slowing significantly even as industrial production and business sales recover. Rising output is not typical of a business cycle recession. Nor are rising business profits after a year of decline. So, while there may be a “labor recession” in 2024, we believe moderating interest rates and increases in corporate profitability will drive gains for equity markets.

In 2023, manufacturing output, trade and housing contracted across the world in ways that are very typical of recessionary periods. In contrast, labor-intensive services industries were rebounding, driving employment gains (**Figure 1**). We therefore call 2023 a period of “rolling recessions”.

Industries that are deep in recession now, for example residential real estate, are not producing enough output. And during the rolling recessions of 2023, there was a broad drawdown in manufacturing inventories. This means that as the economy normalizes in 2024-25, these sectors are likely to rebound, even if services growth slows.

Figure 1: US Manufacturers New Orders Index vs Private Services Employment Y/Y%



Source: Haver Analytics as of December 1, 2023. **Past performance is no guarantee of future results. Real results may vary.** Remember that for the US, 2021 was the last strong growth year. The subsequent three-year malaise was largely a result of supply/demand imbalances from COVID and wild swings in fiscal/monetary stimulus. Many non-US economies suffered worse. In our view, the asynchronous characteristics of the COVID period are ending in 2024-25.

Q2: Will sticky inflation keep the Fed from cutting interest rates?

A: The inflation rate in the US peaked at 8.9% in June 2022. Inflation was fueled by excessive fiscal and monetary stimulus designed to bridge the US and global economies across the pandemic, by dislocations in supply/demand relationships and by geopolitical issues, including the war in Ukraine. The Fed’s actions to support the economy were its most accommodative actions since WW2.

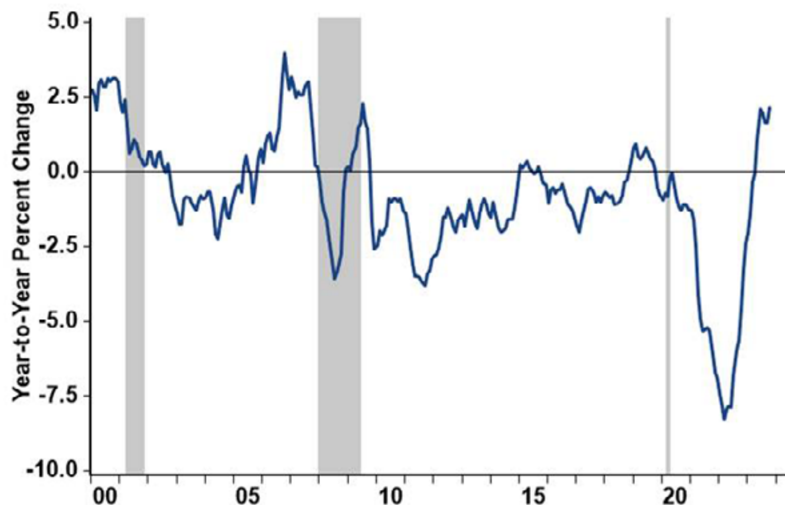
Therefore, when the Fed started hiking rates, it was not raising them from a neutral rate. The Fed was, itself, a source of inflation. The real Fed funds rate (Fed Funds Target minus year-to-year Headline CPI) was an astonishing -8.3% in March of 2022. That was 2x more accommodative than the Fed was during the ’08-09 financial crisis.

The current inflation rate in the US is 3.2% as of October. That is a 5.7% drop in just 16 months. Therefore, it is hard to argue that inflation is sticky. In fact, finished producer prices (-0.4%) and import prices (-2.0%) have actually fallen year-over-year. Core prices *excluding shelter* are up just 2% year-over-year. And shelter, the greatest laggard in the CPI, is coming down sharply as home price appreciation ends. Lagging indicators, like shelter, roll out of the CPI over 12 months (see more in our November 19 Bulletin).

We all recognize that If inflation remained at 2022 levels the Fed would not cut rates. But many indicators suggest that inflation will be at 2.5% by year-end 2024. And with expected increases in the unemployment ahead, we believe that the Fed will turn its intention to maintaining US employment.

As we have written in a recent bulletin, since 1980, employment growth has averaged +146K per month in the six months prior to the Fed cutting rates. More often than not, Fed action anticipates a downturn in the economy. While the recent memory of high inflation and rising home prices may keep the Fed from cutting aggressively, the Fed is likely to recognize the need to act in 2024.

Figure 2: Real Fed Funds Rate



Source: Haver Analytics as of December 1, 2023. Grey areas are recessions. **Past performance is no guarantee of future results. Real results may vary.**

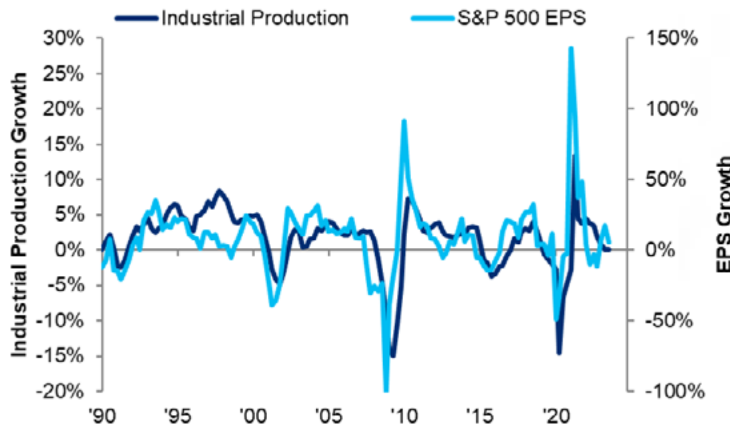
Q3: How can corporate profits rise if the labor market slows in 2024?

A: American corporate profits, while linked to overall US economic activity, do not follow trends in the US labor market linearly. The economic factor most closely correlated to corporate profits is industrial production, which has lagged payrolls growth for much of the past year. Given our view that "rolling recessions" will end in 2024, we expect a broadening of US industrial activity next year. Note that a greater share of S&P 500 constituents is engaged in goods-related production, whereas there is a greater proportion of US jobs engaged in service businesses.

Consistent with rolling recessions in manufacturing and goods trade, S&P 500 profits declined in the first half of 2023 (**Figure 3**). Looking now at both manufacturing and services, we see tailwinds. For manufacturing, it's the rebuilding of inventory and a reduction in input costs, including imported components that leads to better profitability. For services, a normalization of demand for travel and leisure, construction and certain health services will reduce labor demand and labor inflation, allowing for greater margins.

While wages in aggregate tend to move in line with total profits, falling unit labor costs are typically supportive for corporate profit margins. Moreover, the post-COVID inventory overhang has subsided, providing an additional tailwind as "trapped" earnings get unlocked. All of this suggests that US corporate profits can rise by 5% in 2024 and a further 8% in 2025, an excellent backdrop for US equities.

Figure 3: Industrial production vs EPS



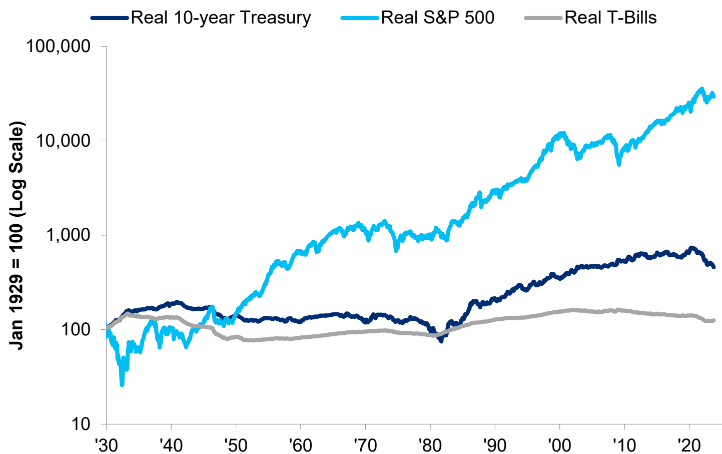
Source: Bloomberg and FactSet as of December 1, 2023.Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. **Past performance is no guarantee of future results. Real results may vary**.

Q4: What's the right amount of cash to hold?

A: For many investors, the allure of 5% overnight cash rates remains high. After all, if you can get 5% in money market funds, why not take the interest and run? Today money market fund assets in the US are $5.8T[1] so investors are obviously similarly inclined. With the Fed holding their short-term rates at peak levels for now, this may seem a conservative strategy. For some, cash is being held aside to make opportunistic future investments. For other, cash is "safe money" for emergencies. But both rationales may lead to contradictory outcomes.

We have written many times about the fact that cash is a poor long-term investment and, most often, reduces portfolio returns. In 2022, that was not the case as both fixed income and equities lost money. But it has not been true in 2023. Over most periods, cash performs less well that Treasurys and equities (**Figure 4**).

Figure 4: Real (Inflation Adjusted) Returns for Stocks, Bonds, Cash (Log Scale)



Source: Haver Analytics as of November 20, 2023. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. **Past performance is no guarantee of future results. Real results may vary.**

[1] Source: ICI, Bloomberg as of December 2, 2023.

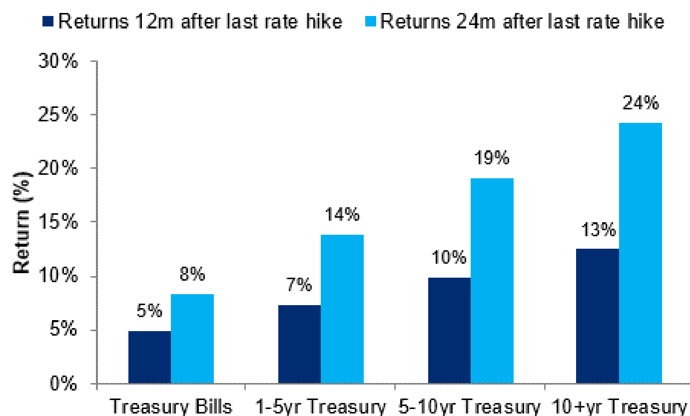
As outlined in our forthcoming Wealth Outlook 2024, the right amount of cash for portfolio purposes is low, just 1% of our recommended asset allocation. Here are three reasons:

The first is that the Fed is unlikely to keep rates at these levels. Assuming the Fed believes inflation is under control, it typically begins to reduce short term rates as employment growth stalls. In fact, in 10 of the past 11 easing cycles, the Fed has reduced rates before the start of recession and rising unemployment. This means that money fund rates are likely to drop rates by 1.0-1.5% by year end ‘24.

Second, by moving from cash to intermediate bonds, the risk-return leans in favor of investors. Bond buyers today may lose a bit on a mark-to-market basis if rates rise for a while, but the potential gains from bond ownership are more favorable today (**Figure 5**). While an investor earns a coupon of more than 4%, they may also see appreciation in their bond portfolios. On average over the past 30 years, a 5–10-year duration Treasury has gained 10% and 19% over a 1- and 2-year period, respectively, after the Fed’s last rate hike.

Finally, as we reset our strategic return estimates, cash remains the poorest long-term performer. Cash yields rarely exceed the inflation rate and often dip below it. So, in addition to losing real value as a unit of currency, the cash not invested in markets in broadly diversified portfolios is associated with a significant opportunity cost, as well. In short, it is hard to argue that having excess cash is a value-added decision in a normalizing global recovery.

Figure 5: US Treasury Returns by Duration After Last Rate Hiker of Cycle (1994-2023)



Source: CGWI Global Asset Allocation and Quantitative Research, and Bloomberg. Analysis as of October 31, 2023. Rate hike refers to an increase in the Federal Funds rate. Rate hike dates included in this analysis are from February 1995, May 2000, June 2006 and December 2018. The chart contains the average of the cumulative total unhedged returns for the stated indices over the 12 months following the four aforementioned rate hike dates. Treasury bills are represented by the Bloomberg US Treasury Bill Index. 1-5yr treasury is represented by the Bloomberg US Treasury 1-5 years Index. 5-10yr treasury is represented by the Bloomberg US Treasury 5-10 years Index. 10+yr treasury is represented by the Bloomberg US Long Treasury Index. The indexes are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. **Past performance is not necessarily indicative of future returns. Real results may vary.**

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Upper medium grade (Strong)	A	A	A
Medium grade	Baa	BBB	BBB
Not Investment Grade			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
In default	C	D	D

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