Key Takeaways to Start the Year

January 4, 2024

A SNAPSHOT AND AN OUTLOOK

At Strategas, we look at the markets and the economy from several angles. Periodically, we gather our separate research areas into one note that serves as a snapshot of both where we are today and an outlook for the months ahead. As we start a new year, we thought it would be useful to undergo this exercise for our clients once again.

INVESTMENT STRATEGY: JASON TRENNERT, CHIEF INVESTMENT STRATEGIST, CHAIRMAN

- **Inflation.** The rate of inflation appears to be declining to a point where the Federal Reserve will feel comfortable cutting interest rates in pursuit of slowing inflation without impacting employment. This sort of soft landing is rare after monetary tightening of this magnitude.
- **Elections.** More than 40% of the world's population (and 80% of its stock market capitalization) faces national elections in 2024 and incumbents have an incentive to avoid recessions. Our forecasts must include consideration of the tools that fiscal and monetary policymakers can use to this end. Some will render valuation less important in the short term and we will rely more on technical analysis where appropriate to help investors take advantage of tactical opportunities.
- **Markets.** We appear to be in a risk-on environment for investors. But with the S&P 500 trading at 19x forward earnings—and investors simultaneously expecting 12% earnings growth and more than 5 rate cuts from the Fed—double-digit S&P 500 returns may be difficult to achieve.
- **Geopolitics.** The costs of deglobalization—a higher cost of doing business, supply chain disruptions, and greater defense spending—are likely to be more apparent in 2024.
- **Fiscal.** With budget deficits around 6% of GDP and debt-to-GDP at roughly 100% (despite an economy near full employment), we believe the laws of financial physics cannot be suspended indefinitely. Eventually, the country will need to either 1) accept higher levels of inflation and interest rates as a natural state of affairs, 2) seek some form of fiscal austerity, or 3) hope that higher productivity allows the private sector to step up in a big way. The value of the U.S. dollar should be a good indicator of the country's willingness (or ability) to bring itself back into fiscal balance.
- **Investing.** For long-term investors, we continue to favor companies that generate enough cash flow to grow without a significant reliance on outside capital, unless and until the Fed decides to expand the size of its balance sheet once again.

ASSET ALLOCATION: NICHOLAS BOHNSACK, PRESIDENT, HEAD OF PORTFOLIO STRATEGY

Click here for our full Asset and Sector Allocation Framework

- **Equities.** We are taking a more bullish line on the back of the Fed's pivot toward easier monetary policy. The consensus on the U.S. economy has shifted from "cautious-to-bearish" to "cautious-to-bullish." Stronger-than-expected Q3 corporate earnings and economic growth, an increasingly supportive fiscal backdrop, and a Goldilocks inflation/labor market mix has fueled animal spirits. Absent an exogenous shock, we don't foresee much to discourage investors' bullishness in the near term. **Although imbalances in domestic and global economies keep us cautious, current conditions warrant a more pro-cyclical portfolio construction.** We have increased our Equity positioning to Neutral against a 60/40 benchmark and increased our exposure to Large-Cap Growth in particular. On the sector front, we are overweight Industrials, Health Care, Consumer Discretionary, and Communication Services.
- **Fixed Income.** We have reduced our fixed income exposures in conjunction with the view outlined above. The drop in long-term bond yields since late October has been just as rapid as the rise was before it. We used that late-summer rise

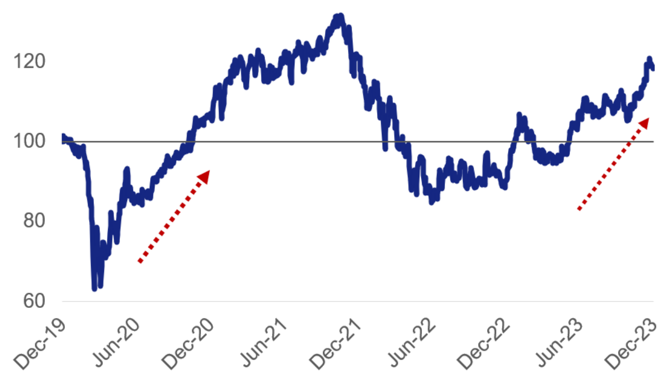
in yields to add duration to our Treasury holdings (higher duration bonds respond more aggressively to changes in interest rates – in both directions). With yields now 0.50 percentage points below our entry point in some cases, we have taken profit and reduced duration (though we remain slightly long duration versus our benchmark). These markets require more tactical portfolio adjustment than would typically be necessary. **Ultimately, the market appears convinced that inflation will slow further in the very near-term (we agree) and that the Fed will be extremely accommodative in early 2024 (we're less convinced).** This dynamic does suggest, however, that the rally in bonds still has a way to go—and we are positioned as such.

TECHNICAL STRATEGY: CHRIS VERRONE, HEAD OF MACRO AND TECHNICAL STRATEGY

- **Stocks.** The burden of proof is on the bears, with the market's up-trend intact and momentum supportive under the surface (20-day highs have surged recently and 90% of stocks are above their 50-day average).
- **Election years.** Presidential election years are known for surprises and weakness early in the primary season is historically common—but absent major signs of deterioration or pronounced shifts in leadership, we'd view setbacks as opportunity.
- **Notable trends.** European yields are further along in their topping process (compared to U.S. yields), the U.S. dollar is under pressure and the Japanese yen is strengthening. The yen has the potential to be a big story in 2024.
- **Economy.** With yields and oil under pressure, the more difficult question to start 2024 is how fine the line is between an easing of financial conditions and an economy in trouble. We certainly don't know, but we're more comfortable in following the market's intuition over our own. Relationships like Discretionary vs. Staples (see right) or Industrials vs. Utilities will help to answer this question in real time.
- **Leadership.** On the leadership front there are hints of life from the equally weighted Indices (the "average" stock), but it's premature to say the reign of the Magnificent 7 (Large Tech / Growth) is over. The same is true for Value vs. Growth: the potential is there for a sea change (perhaps with a weaker dollar as the catalyst), but it is as of yet unconfirmed.

The Discretionary vs. Staples "Risk-on" Barometer

S&P 500 Consumer Discretionary relative to Consumer Staples (equal-weighted)



ECONOMICS: DON RISSMILLER, CHIEF ECONOMIST

- **Inflation.** Inflation has been painful in many countries over the past several years. The first wave of inflation now appears to be over, and that's likely to remain the case as we move through the first half of 2024. But history suggests that once inflation gets going, a second wave tends to build over the subsequent years (with a hit rate of 87% of the time globally).
- **Growth.** The U.S. economy has seen only spotty economic weakness thus far, particularly compared to the more significant weakness in other countries. Still, there should be a continued downward pressure on activity in the first half given the lagged effects of policy already in place (i.e., higher interest rates). But by the second half of the year, some of those effects should be fading. So the window for the U.S. economy to weaken significantly is likely from now until mid-2024. **We are using a 50% chance of a U.S. recession, 40% soft landing, 10% upside surprise in 2024. For 2025, our odds are a 15% chance recession, 60% soft landing/expansion, and 25% upside surprise.**
- **Policy.** After tightening policy aggressively, many central banks seem to be attempting a pause (albeit in restrictive territory). This year likely involves a pivot to lower rates, justified first by inflation coming down. The Fed has telegraphed three rate cuts for this reason. Printing a negative GDP reading and/or getting a negative employment report in the U.S. would likely lead to more rate cuts than the Fed's current "soft landing" projection.

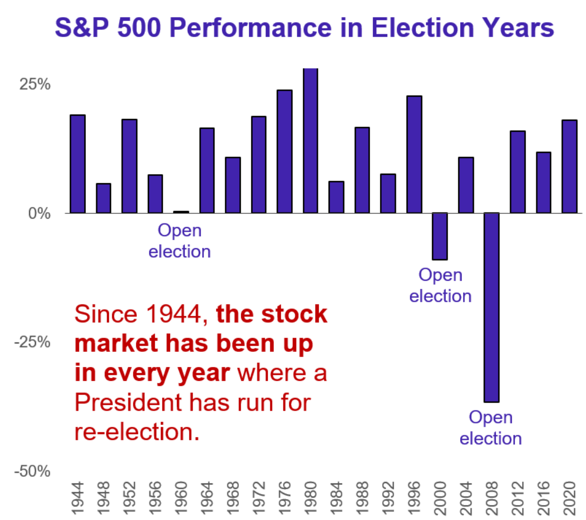
- **Risks.** The U.S. has been an outperformer and key to global growth. Yet there remain 5 key elements of the U.S. soft-landing story that we don't fully subscribe to: 1) The economy can take higher interest rates and grow indefinitely; 2) The lagged effects of prior policy and bank tightening have been fully digested; 3) Continued U.S. unemployment under 4% will be accompanied with acceptable wage inflation; 4) The local labor market is moving to a state of balance by cutting only job openings vs. jobs; 5) Markets (bonds, equities, housing, etc.) can handle structurally higher interest rates from here.

- **Hope.** Productivity (worker output per hour) can conceptually help alleviate a second inflation wave. Too much money chasing too few goods can be stymied … by producing more goods. While there is promise on this front from technology advances, we need to see more confirmatory economic data to be convinced.

WASHINGTON POLICY: DAN CLIFTON, HEAD OF POLICY RESEARCH

- **Stocks do well in presidential re-election years.** On a total return basis, the S&P 500 has increased in every presidential re-election year since 1944. Performance in presidential re-election years is stronger than open election years (i.e., no incumbent) by 13% on average. We believe this happens because policy becomes more accretive ahead of a President seeking re-election.

- **Policymakers are already deploying economic tools.** President Biden has a wide set of tools available to him to boost the U.S. economy, and some of these tools are already being deployed. Most notably, the Treasury made a decision in November to finance the budget deficit with more short-term Treasury bills rather than increase long-term debt issuance. This injected liquidity into the economy. Moving forward, we expect Treasury to pass the baton to the Fed, with multiple rate cuts expected in 2024 (and talk of quantitative tightening ending mid-year). US oil production is at a record high, helping to offset non-US production cuts. Finally, President Biden's infrastructure, clean energy, and CHIPs funding also comes online in 2024.



- **And more tools are available.** A couple of items can add to the election fiscal policy tailwind. First, a resumption of the Employee Retention Tax Credit. This program added $150 billion of new stimulus in 2023 and is directly correlated to a boost in small business hiring and the surge of 3Q GDP. The program was halted because of fraud, but the IRS can restart the program with no act of Congress. Second, there is an effort to get a bipartisan tax deal completed in the first half of 2024 that expands the Child Tax Credit and reinstates business tax provisions that previously expired.

- **Expecting a chaotic first quarter.** The economic tools outlined above are important because there will be lots of noise this presidential election year. In fact, the list of political and policy catalysts is as long as we can remember. For instance, the Supreme Court will very quickly need to make a number of legal decisions that will impact the U.S. election. Voting in Iowa and New Hampshire starts in January. Congress will be trying to avoid a government shutdown with specific spending cliffs coming up in late January and early February. Congress will also be trying to secure a border enforcement for Ukraine funding deal on top of the budget issues. And the Taiwan election is January 13. **Interestingly, the S&P 500 usually comes under pressure around Super Tuesday in presidential re-election years as the nominee emerges.**

- **Range of outcomes wide.** Roughly 70% of voters do not want Biden or Trump to be the nominee and yet that is where the election is headed. If Trump wins Iowa and New Hampshire, then he will likely win the Republican nomination very early in the process. We would be more bullish on Nikki Haley beating Trump if she was able to win both New Hampshire (January 23) and South Carolina (February 24). If Trump is the nominee, we expect Biden to stay in the race, knowing that Democrats would become divided over his replacement if he left the campaign. Biden's numbers are weak even as economic growth has done well and gasoline prices have come down, leaving Democrats worried that Biden will weigh on Senate and House candidates down ballot if this holds.

FIXED INCOME: TOM TZITZOURIS, HEAD OF FIXED INCOME RESEARCH

- **2023 vs. 2024.** A major difference between this year and 2023 is that inflation is now down to a more comfortable zone (though still not where the Fed wants it to be). This means that, at baseline, yields across the curve should be lower this year as the Fed now has the scope to cut short-term interest rates by the second half. What's also different is that the Fed is likely to end balance sheet reduction this year, though when is perhaps the more important question. Our best estimate is early third quarter, but there are calls to slow the pace now and end it by June.

- **What's the same?** The labor market is still at full employment, which means that either wages need to decline or productivity needs to rise, or else inflation will begin to rise again with any easing of financial conditions. What also hasn't changed is that Treasury bond supply is going to be off the charts of the historical norms, and at some point coupon supply will need to rise again, putting upward pressure on longer-term bond yields. Likewise, the Fed is still reducing its balance sheet for now, which means there's still a liquidity drag from the Fed, at least for the first half of 2024.

- **Whereto for yields?** At baseline, yields should be lower in 2024 vs 2023. But how much lower? If we assume a soft landing that transitions toward another expansion (with the economy at full employment no less), then we're likely near the lows in yields for 2- to 10-year Treasurys. But investors are pricing in more rate cuts than we would argue is reasonable for a soft landing. As of now, futures are pricing in ~150 basis points of cuts for this year (1.5%), where we might argue for 50 to 75 basis points of cuts in a soft landing. Until the Fed dispels the market of first half rate cut thoughts, investors are likely to keep pushing short-term yields lower.

- **Recession?** If the economy heads toward recession, the baseline level of yields moves even lower, with scope for the Fed to cut upwards of 250 basis points over the next 18 months, allowing for the 0- to 3-year portion of the curve to move below 3.5% and the 5- to 10-year bucket to move to roughly 3.5%. At this point, it's almost a 50-50 call whether the U.S. hits recession this year or continues along at full employment from the steady dopamine drip of D.C. stimulus.

- **Spreads tight.** Corporate credit spreads (the yield above a comparable Treasury) have gradually inched lower from their cycle highs set in late 2022, just as yields have dipped. This has allowed longer duration investment grade corporates to claw back a major chunk of their losses since 2021. **Much like the start of 2023, the market for risk assets is pricing in something better than a weak economy, and with investment grade credit spreads below 100 basis points, the view is more of strong growth than a soft landing, let alone a recession.** At baseline, spreads should widen in 2024 as supply pressures, soft landing weak spots, and continued profit margin compression in some sectors should put upward pressure on spreads. But the difference between soft landing (investment grade spreads around 120 basis points) and recession (IG spreads around 200 basis points) is material.

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