January Investment Outlook 2024

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Current Market Conditions

Market Rally Continues in December

Markets closed out 2023 with a strong rally in December. The S&P 500 was up 4.5%, while smaller U.S. companies, developed international, and emerging markets were up 12.2%, 5.3%, and 3.9%, respectively. For the full year 2023, the S&P 500 was up 26.3%, while small cap U.S. stocks, international developed markets, and emerging markets were up 16.9%, 19.0%, and 10.1%, respectively. The primary driver of the S&P 500 returns in 2023 was the Magnificent Seven stocks (Apple, Amazon, Alphabet, Microsoft, Meta, Nvidia, and Tesla), which were up over 75% in 2023. The S&P 500 was still up over 12%, excluding these seven stocks.

Interest rates declined in December, with the two-year U.S. Treasury Note falling from 4.7% to 4.2%, and the ten-year U.S. Treasury Bond declining from 4.3% to 3.9%. Given the decline in rates, the broad measure of fixed income returns increased by 3.7% in December, pushing the full year total return to 5.7%. Commodity prices overall declined by -3.1% in December, with oil declining -6% to $72 per barrel.

Key Dynamics to Focus On in 2024

After a year of gradually improving economic trends and solid capital market returns, we are looking for indications that the positive momentum can continue through 2024. In the December edition of our Investment Outlook, we examined the factors that influenced results in 2023. This month's Outlook examines the critical factors to watch for in 2024, how they could impact returns in the year ahead, and how they affect our views on portfolio positioning and asset allocation.

Primarily due to the Federal Reserve Board's (Fed) program of raising short-term interest rates, inflation has fallen significantly from peak levels over the last 18 months. January's Consumer Price Index (CPI) reading of 3.4% is well below the 9.1% high reached in mid-2022. Consensus estimates provide for inflation to continue declining over the next year,

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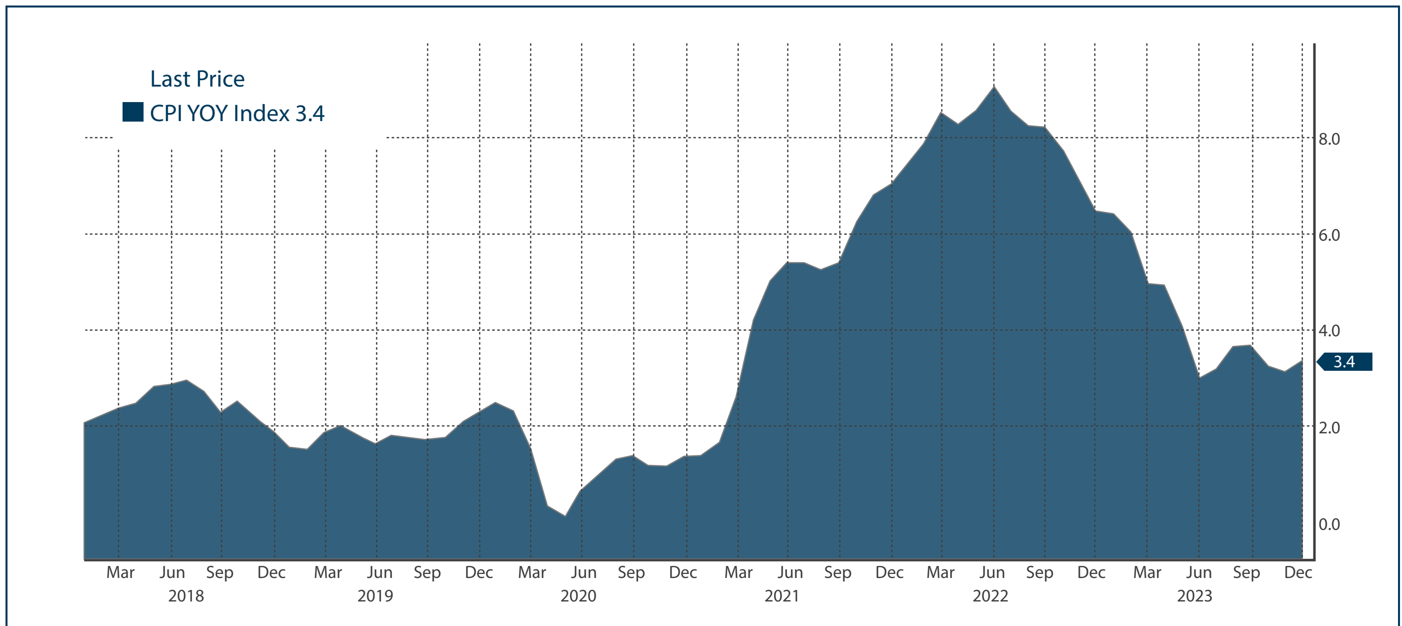

Source: Bloomberg

with CPI expected to average 2.6% in 2024. As inflation approaches the Fed's target rate of 2%, controlling inflation becomes a bit more challenging as it requires wringing the last bit of excess from the system. Given how crucial inflation is to the Fed's views on interest rates, and how important interest rates are to investor sentiment and market returns, it is worth exploring that in more detail.

There are several factors that could cause inflation to stall or plateau above the Fed's longer-term target levels. One important consideration is the individual components of inflation. While prices for goods, food, and energy have retreated sharply off their peaks, the impact of shelter costs and other services are still exerting a significant impact on CPI. As Richmond Federal Reserve President Tom Barkin notes, this presents a risk that "inflation levels off at a cruising altitude higher than our 2 percent target." And adjusting the target is not an option, as that would cause the Fed to lose credibility, which is the Fed's "key asset."

Another factor that could make it challenging to further reduce inflation is that the U.S. economy is performing better than expected. In the chart on the next page, unemployment remains near record lows, and a recent survey of consumer sentiment shows consumers are as optimistic as they have been since 2021. Retail sales data for December also came in ahead of views. While this sounds encouraging from a broad economic perspective, too much strength in the economy at this point in the cycle could make squeezing out the last bit of inflation more challenging.

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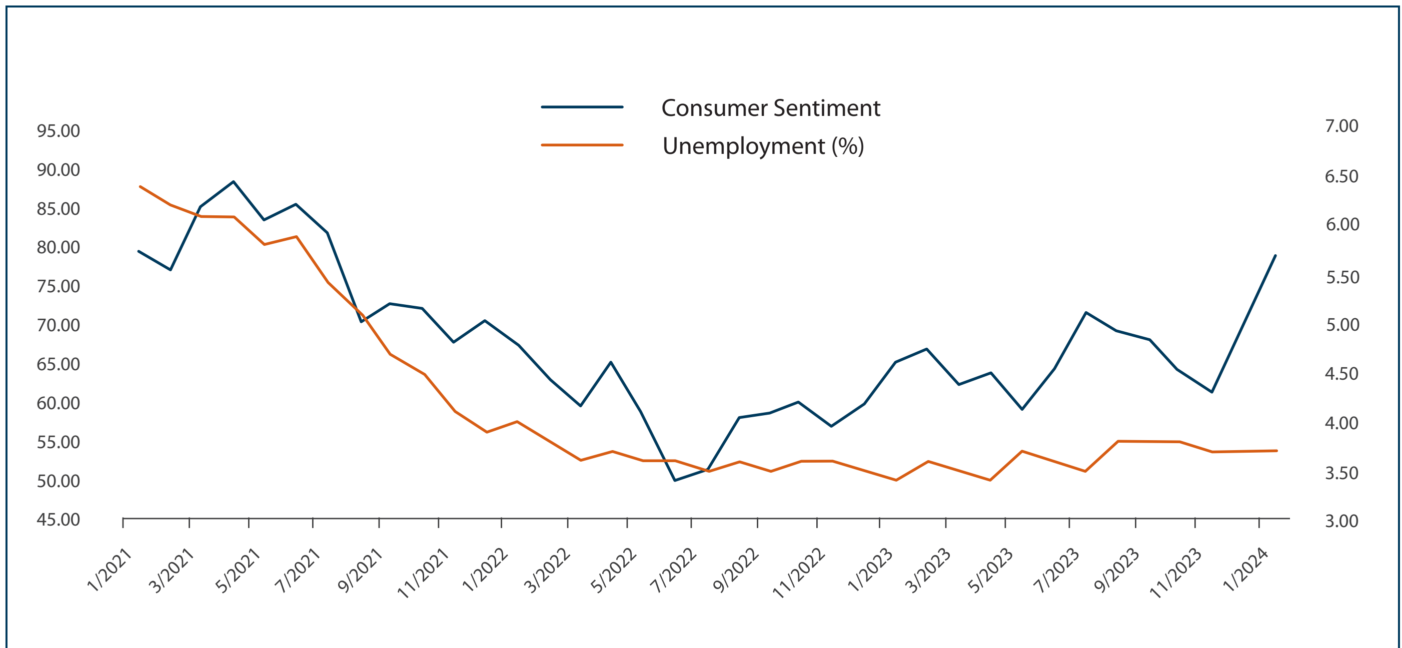

Source: Bloomberg , Klingenstein Fields Advisors

The possibility exists that, despite the recent positive momentum in some of the economic indicators, the real impact of the high level of interest rates has yet to be felt. It can take years for the impact of higher interest rates to be fully apparent in economic results. In contrast to the previous considerations, this could lead to a more significant economic contraction than is expected, and, if detrimental enough, it could even result in inflation falling below the Fed's targets.

These conflicting currents highlight one of the most significant dynamics for capital markets heading into 2024: the delicate balance between the overall health of the economy and the Fed's targeted interest rates levels. Lower interest rates in the near term are generally more bullish for equity markets but likely require economic activity to soften a bit. From a longer-term perspective, solid economic growth is needed to drive corporate earnings and markets forward.

As shown in the chart on the next page, the consensus view is for Gross Domestic Product (GDP) to slow somewhat in 2024 and gradually start recovering through 2025. This is in line with the "soft landing" environment that markets currently anticipate. In this scenario, economic growth slows enough for inflation to stabilize at levels that will allow the Fed to lower interest rates, without slowing so much that the economy falters. This is sometimes referred to as a "Goldilocks Economy" – not too hot and not too cold.

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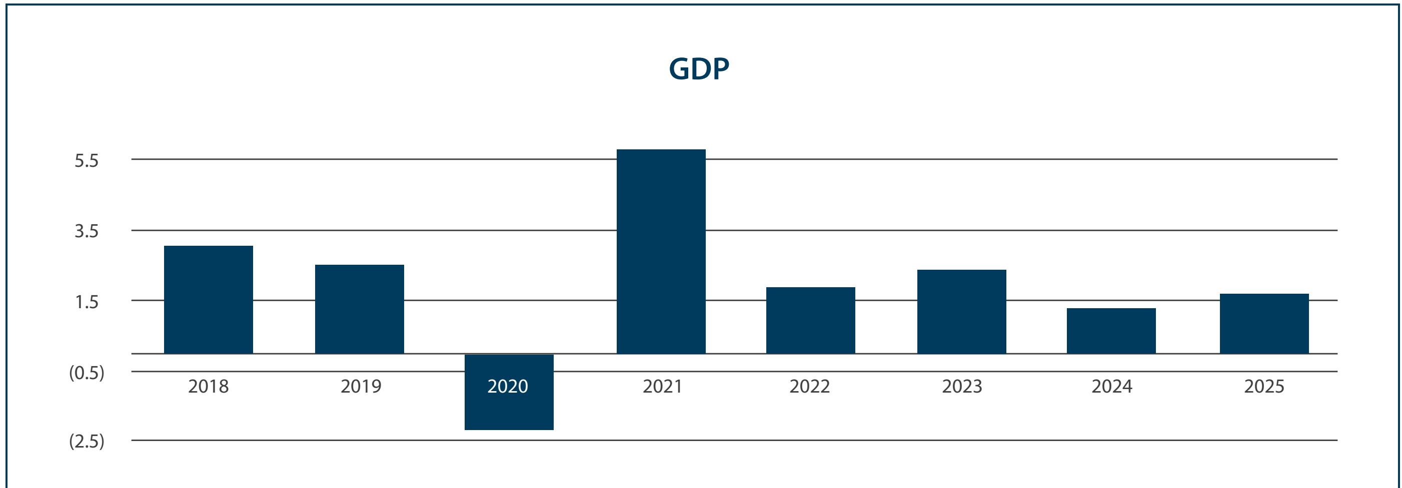
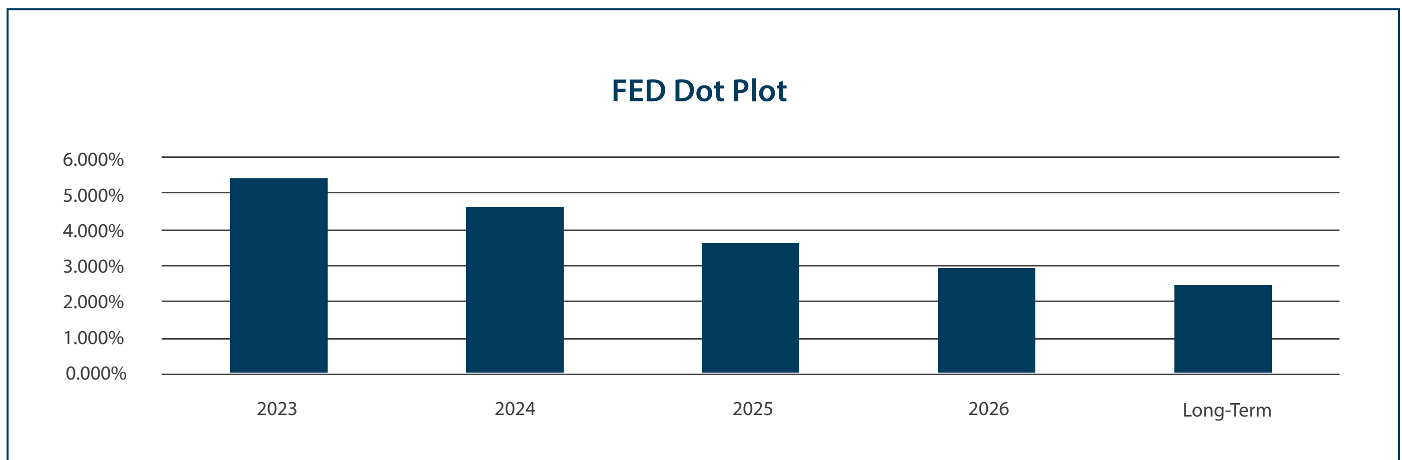


Source: Bloomberg , Klingenstein Fields Advisors

Given the recent trajectory of the economy and inflation, it appears that the Fed expects to begin reducing interest rates in 2024. The chart below is the consensus view of senior Fed officials on interest rates over the next few years. By the end of 2024, Fed officials on average expect interest rates to decline by 0.75%, representing three interest rate cuts of 0.25% each. Investor forecasts on the other hand seem more optimistic, pricing in about five such moves over the course of 2024.

After having belatedly responded to the onset of inflation, the Fed is likely to approach the reduction in interest rates with caution. Therefore, the difference of opinion here between the Fed and investors on how fast rates come down is understandable, but ultimately will need to be reconciled. If the number of rate cuts falls significantly short of investor expectations, markets may only post modest gains over the next year. On the other hand, should the inflationary environment turn out to be more benign and allow for more significant rate cuts, that will likely be quite positive for capital markets.



Source: Bloomberg , Klingenstein Fields Advisors

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S&P 500 Election Year Returns

Year	S&P 500 Return	Year	S&P 500 Return
2020	18.4%	1972	19.0%
2016	11.9%	1968	11.0%
2012	16.0%	1964	16.4%
2008	-37.0%	1960	0.5%
2004	10.9%	1956	6.5%
2000	-9.1%	1952	18.2%
1996	22.9%	1948	5.4%
1992	7.6%	1944	19.5%
1988	16.6%	1940	-9.6%
1984	6.3%	1936	33.7%
1980	32.5%	1932	-14.8%
1976	23.9%	1928	37.9%
Election Year Avg	**11.0%**		
All Years	**9.55%**		

Source: Bloomberg , Klingenstein Fields Advisors

Geopolitical issues remain a significant factor heading into 2024. The conflicts in the Middle East and Ukraine have the potential to expand into larger struggles, creating more significant global crises. Tensions in Asia could also boil over into a more volatile situation. Closer to home, the U.S. is entering a presidential election year. This is generally a small positive factor for equity returns. Although the number of election data points remains limited, it is likely that the prevailing economic environment will have a more significant impact on market returns. Nevertheless, on the margin, should the economy start to look tepid, Washington could try to ameliorate the situation through spending or other means at their disposal, which could support the economy and likely support capital markets.

How We Are Positioning for The Year Ahead

Heading into 2024, we have more clarity around the trajectory of interest rates, inflation, and economic growth than we did a year ago. It is likely that the damaging levels of inflation are behind us, but there is still some work to be done to bring inflation in line with longer-term targets. A deep recession seems less likely now than it did a year ago, but a mild one is still possible. It is likely the Fed will begin to cut

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interest rates in 2024, but when that begins and how far rates will decline remains uncertain. These ongoing tensions, especially after solid equity returns in 2023, will likely lead to increased volatility in capital markets through the course of the year. While the longer-term picture remains encouraging, in the near term, it is possible that significant pullbacks could occur as investors digest economic data and the potential impact on interest rates.

Our Investment Strategy and Approach

While there are risks as we head into 2024, from a long-term perspective, we are still constructive on equity exposure, as we believe that the near-term risks are reasonably balanced out with the longer-term potential returns. We remain cautiously optimistic and are not making any major changes to our high-level asset allocation policies. Should we see material improvements or deteriorations in the factors discussed, we would likely look to adjust portfolio positioning. Beyond higher level asset allocation considerations, we continue to look for quality managers and companies, as well as favoring higher quality fixed income investments over higher yielding but riskier investments. We think that it is imperative that as the dynamics outlined above unfold, investors will need to balance patience with being nimble and responsive to the changing environment.

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