NEIRG
Wealth Management | A Connectus Partner

2024 Outlook

Prepare Not Predict

Interest Rate Challenges into Opportunities

January 2024

Key Observations

- We believe range-bound inflation opens multiple paths to lower rates creating opportunities for tailwinds in fixed income and more rate-sensitive assets.
- The most predicted recession in history continues to shift into the future, however, we also believe investor mindsets should shift from predict to prepare as risks remain acute and market timing futile.
- Narrow market leadership in U.S. equities creates fragility within, and opportunity outside of, U.S. technology stocks. We believe long-term investors will benefit from exposure to U.S. small capitalization and non-U.S. stocks.

2023 was defined by a few key themes:

- Continued volatility was clearly on display with interest rate volatility not seen since the Global Financial Crisis and while headline equity volatility didn't set new records, the subtext is important. The stark contrast between -100%[1] losses seen in select bank failures and the 200%+[1] gains with some Artificial Intelligence (AI) hype is enough to make heads spin.
- Moderating inflation was a resounding call as inflation fell from annualized highs of 9.1% in 2022 to 3.2% in October 2023.[1]
- Bear Market Bottom - Equities globally, but the U.S. in particular, rallied from October lows in 2022 to July 2023 highs by 28.3%.[1] While our outlook themes made the grade, that is not to say the crystal ball was spotless. A banking crisis, U.S. Debt downgrade, military conflict in the Middle East and an AI super cycle were not on our radar.

[1] FactSet as of November 30, 2023

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2024 Themes

A central thread that pulls through our 2024 themes is a favorable shift toward fixed income. Over 2022 and 2023, investor views of fixed income shifted from complacency to animosity to indifference. They also reestablished a long-lost relationship with a forgotten asset, cash. Today our 2024 themes, while each distinct and catalyzed by different circumstances, stand in contrast to our earlier writings. What an extraordinary and strange journey fixed income has been on.

The Messy Middle

There is a lot of back patting and handshaking that can be done regarding inflation at the Federal Reserve (The Fed). Inflation has fallen from its peak of 9.1% in 2022 to 3.2% in October 2023. [1] Some market participants are concerned more work is needed given we remain above the stated 2% average target. Rather, we dismiss 2% as an actual level that must be achieved precisely and believe “normal” inflation is more likely destined to settle higher.

First, 2% is, after all, an arbitrary number. It is far enough away from central bankers’ worst fear, deflation, yet it is below a level of inflation that consumers start noticing (~3%).

Second, it is our view that the Fed is less likely to risk the collateral damage of continued rate hikes, such as adding fragility to the banking system, just for the modest benefit of moving inflation from 3% to 2%. So, if not 2%, what is the target?

We call it the “messy middle”, an inflation range of 2% to 5% and one we believe we will be in for some time. The days of asleep at the wheel 2% inflation where the deflationary tailwinds of globalization are waning. So too are the extraordinary supply-side shocks and consumer revenge spending from COVID.

This range is one that compels vigilance from the Fed that inflation does not rise meaningfully above it, but it is also a range we believe the Fed can use as justification to cease hiking or even begin to cut rates.

[1] FactSet as of November 30, 2023

Multiple Ways to Trim

	Terminal Fed Funds Rate		Rate of Inflation
May-74	13.00%	←	10.10%
May-81	20.00%	←	10.00%
Aug-84	11.75%	←	4.20%
Feb-84	9.75%	←	4.70%
Feb-95	6.00%	←	2.80%
May-00	6.50%	←	3.10%
Jun-06	5.25%	←	4.20%
18-Dec	2.50%	←	2.20%
Sep-23	5.50%*	←	3.70%

With inflation stuck in the messy middle, that means rates have room to move lower.

Since 1954 the average real Federal Funds Rate (Fed Funds less annual inflation) is 1.01%[1]. Today the real Fed Funds rate is 1.8%. Moreover, this restrictive stance has grown even though the Fed has paused as inflation continues to fall. This signals to us not only do we believe the Fed is at the end of its hiking campaign, but there is room to cut.

The prevailing view is lower rates are achieved from an economic slow down in which the Fed could cut meaningfully. However, that is not the only case. A soft landing in which the Fed simply reduces its current restrictive stance could also move rates down producing multiple paths lower.

**5.5% is the Fed Funds Rate as of June 30, 2023. It does not imply 5% will be the terminal rate*

Source: Federal Reserve Bank of Saint Louis, As of November 27, 2023. 1) Federal Reserve Bank of Saint Louis, from July 1954 until October 2023

Don't Predict (Recession), Prepare

Economists may mark 2023 as one of the greatest head fakes of all time. Bloomberg's Here is (Almost) Everything Wall Street Expects in 2023 complied outlooks from 51 institutions, the vast majority of which called for a recession. Quotes like "A recession is all but inevitable" or "2023 will go down as one of the worst for the world economy in four decades". Yet here we sit with U.S. GDP up 4.7%[2] from Q4 2022 to Q3 2023 (the last reported figure). What went wrong? In short, the tenacity of U.S. consumer spending and far better than excepted results of putting the inflation genie back in the bottle led the U.S. economy and markets higher. Does that mean victory should be declared on recession and that fear shelved? In a word - no. In fact, if anything the odds of an economic slowdown have increased. However, we should also plainly acknowledge that a recession is always coming. It may be right around the corner or years away, but recessions are a regular part of economic growth and contraction. We believe seeking to time their occurrence is futile. A resilient portfolio shifts the objective from predict to prepare and, in our view, one of the most effective ways to do so today is with intermediate investment-grade bonds.

[1] FactSet as of November 30, 2023
[2] BLS as of November 29, 2023

Embrace The Inevitable

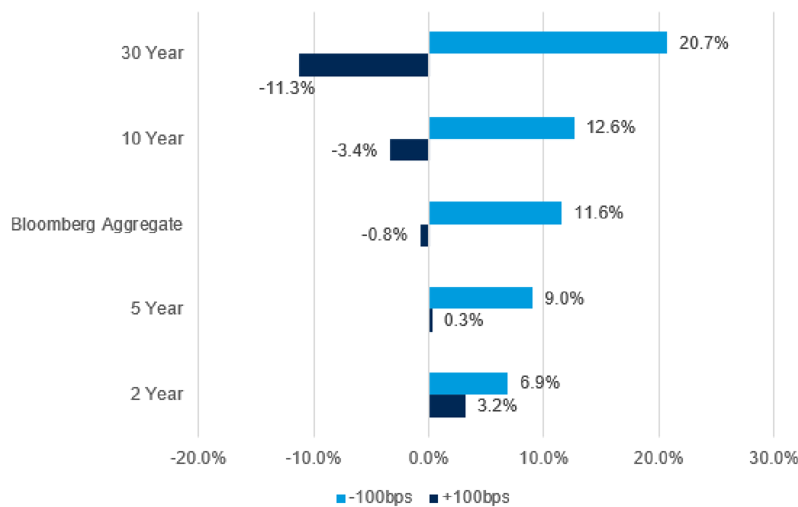
Frequency of Market Events Since 1950

Environment	-5% or more	-10% or more	-15% or more	-20% or more	Recession[1]
Average Frequency	About three times per year	About once per year	About once every three years	About once every six years	About every six and half years
Average Length	43 days	109 days	251 days	370 days	317 days

The unfortunate but inescapable truth is market volatility and recessions are a normal part of investing. Recessions on average since 1980 occur every six and a half years. As long-term investors we should not seek to predict and avoid them, but prepare for their inevitable arrival.

Source: Capital Group. 1) National Bureau of Economic Research as May 2022

May the Skew Be in Your Favor



As we outlined in the messy middle, range bound inflation offers multiple opportunities for interest rates to move lower. Examining the skew of potential return with lower and higher rates reveals the opportunity at hand.

Higher current yields mitigate downside risk through current income. However, the benefit to the upside in return from a fall in rates disproportionately favors longer duration assets. Moreover, if the catalyst for rate cuts comes from economic contraction the move down could be meaningful.

Sources: FactSet as of October 31, 2023. Total potential return based on a parallel move in interest rates up or down by 1%.

Concentrated Consequences

Then came the “Magnificent 7” – Apple, Alphabet (Google), Meta (Facebook), Microsoft, Nvidia, Amazon and Tesla. These seven stocks from the S&P 500 were up on average 94%[3] year to date through November 2023. If we remove

[3] Morningstar as of November 30, 2023

these securities from the S&P 500, through the same period the index would be up ~6%[3]. The seven securities now make up a record setting 28%[4] of the S&P 500 and 48%[4] of the growth-oriented Russell 1000 Growth index. A key question is what impact will this narrow group of securities have on future outcomes? It is possible these securities have a repeat performance over the coming years and indices will grow even more unbalanced with a very concentrated group of securities at the top. It is also possible that these securities revert to broader market-level returns and everything else will catch up as markets charge ahead, but concentration dissipates. However, we think a more likely third path over the long-term is that new leadership takes hold making room for sectors, regions or capitalizations that have been left behind over the past decade. Afterall, this is not the first of its kind.

As we demonstrate below, leadership tends to change over time. In 2000 it was the tech bubble, in the 1990s it was Japanese stocks, in the 1980s it was peak oil, in 1972 it was the "Nifty Fifty" and so on. A retort often heard about the Magnificent 7 today is "but these are great companies" and in many cases they are. However, let's not conflate great businesses and great stocks. Cisco Systems, a gem of the tech bubble, remains one of the world's most influential technology companies more than 23 years since the tech bubble burst. It also still trades 40%[1] below its peak price more than two decades later. Great companies at bad prices can make for bad investments. Additionally, a narrow band of securities contributing to the success of markets intuitively creates more fragility going forward. Much like a sports team, if you lose a star, or multiple star athletes, it is hard to have another step in immediately to take their place.

Market Leadership is Not A Given

Largest Market Cap Securities by Decade

1980: Peak Oil	1990: Japan Dominance	2000: Tech Bubble	2010: Rise of China	2020: US Tech	Current[1]
IBM U.S. | Technology	NTT Japan | Technology	Microsoft U.S. | Technology	Exxon Mobil U.S. | Energy	Microsoft U.S. | Technology	Apple U.S | Technology
AT&T U.S. | Communications	Bank of Tokyo-Mitsubishi Japan | Financial	General Electric U.S. | Industrial	PetroChina China | Energy	Apple U.S | Technology	Microsoft U.S. | Technology
Exxon U.S. | Energy	Industrial Bank of Japan Japan | Financial	NTT DoCoMo Japan | Communications	Apple U.S | Technology	Amazon U.S. | Consumer Dis.	Amazon U.S. | Consumer Dis.
Standard Oil U.S. | Energy	Sumitomo Mitsui Banking Japan | Financial	Cisco Systems U.S. | Technology	BHP Biilliton U.K | Energy	Alphabet U.S. | Technology	Nvidia U.S. | Technology
Schlumberger U.S. | Energy	Toyota Motors Japan | Automotive	Wal-Mart U.S. | Consumer Dis.	Microsoft U.S. | Technology	Facebook U.S. | Communications	Alphabet U.S. | Technology

As investors we tend to extrapolate recent history to set our vision of the future. This recency bias has clearly pointed us in one direction; U.S. large cap technology. However, if we zoom out, we can see that leadership is often more dynamic than what the recent past has instructed. We believe broad exposure remains the best way to seek out opportunities on a forward-looking basis.

Source: Factset. Largest market capitalization companies by decade. 1) As of October 31, 2023

[4] Factset as of November 30, 2023, S&P as of November 30, 2023

Portfolio Impact

A narrow band of securities driving markets has two primary impacts in our view. The first is the temptation to extrapolate recent history at the expense of all other underperforming sectors. This concept can be applied to the technology sector vs others, U.S. versus foreign stocks, or even small cap versus large cap stocks.

The second impact is a narrow market creates more fragility and, potentially, risk. With large cap U.S. securities being the majority of most client allocations, it is important to recognize that potential risk and manage it accordingly. To that end, while reducing the magnitude we are maintaining a similar overweight to U.S. small capitalization and non-U.S. securities. We also believe increased allocations (as we outlined above) to fixed income, investment-grade intermediate duration in particular, help offset these potential risks.

Final Thoughts

The long and variable impact of the momentous move up in interest rates is still being felt and to some degree understood. It has also seemingly taken some of the hubris, though perhaps only temporarily, away from the recession prognosticators. These changes have many important implications for asset prices and the economy. If we step back though, we quickly realize this is a good problem to have. Long-term investors seeking reasonable rates of return no longer must do so by continually extending risk. This was a hallmark of the last decade in which extreme interest rate policies at times produced extreme allocations. As market opportunities "normalize" (if we dare say there is such a thing as a normal market) investors may choose to normalize their allocations with perhaps a more modest risk posture. As we noted, it is important to draw the line between updating portfolios to reflect current opportunities and trying to time the market.

For more information, please contact any of the professionals at NEIRG Wealth Management.

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