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CIO Strategy Bulletin

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A Positive Glidepath for the US Economy

- **This week we released Wealth Outlook 2024: Slow then Grow, Investing in the Markets' Big Reset. We see 2024 as an important transition year that sets the stage for sustainable rates of growth and market returns ahead. Though growth is likely to slow in early 2024, we see no synchronized collapse across the global economy, as many fear.**
- **This Friday's employment report underscores the US economic resilience we discuss in our Wealth Outlook 2024. Despite the fastest rate hiking since the Fed started announcing targets, the US economy has been stronger than most expected.**
- **While some might anguish over the 0.4% monthly gain in US wages in November, most data show the Fed is handily winning the inflation fight with its patience and persistence.**
- **At the moment, markets price the probability of the first Fed rate cut in March at 45%, whereas prior to the employment report the likelihood was closer to 75%. This tells us people were expecting a very quick turn in US monetary policy and a faster decline in demand for labor. Not so fast.**
- **We have little doubt that US employment gains will continue to slow. While there were some strong segment gains in November, only 52% of private industries – barely a majority – added headcount.**
- **When supply and demand meet at a high level as inflation is falling, there is no need to crush the economy and labor markets to bring down inflation. The Fed will likely make this observation and it is one of the key reasons why financial markets have responded positively to reports showing inflation is slowing over the past few months.**
- **We believe that balanced portfolios have the potential for stronger performance over the next decade than has been experienced for some time. Diversification may also diversify portfolios from security concerns and unpredictable election results – two impending risks.**

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A Positive Glidepath for the US Economy

We see 2024 as an important transition year that sets the stage for more sustainable rates of growth and market returns ahead. Though growth is likely to slow in early 2024, we see no synchronized collapse across the global economy, as many fear. The latter half of 2024 should show a return to sustainable economic momentum as well as an improvement in corporate earnings. We anticipate global economic growth to strengthen in 2025. This should become apparent to investors as earnings estimates for 2025 rise. We expect a 12% increase in earnings per share (EPS) over the next two years.

Friday's Data

Friday's data showed a solid US employment gain of 199,000 in November. This followed a very bullish run of inflation data that had dropped US 10-year note yields as much as 90 basis points.

Markets had assumed that employment would be slowing even more this month. As a result, bonds backed up a bit, with the 10-year Treasury ending at 4.23% (+10 basis points). At the moment, markets price in a 45% probability of the first Fed rate cut in March, whereas just prior to the report the likelihood was closer to 75%. This tells us that people were expecting a very quick turn in US monetary policy and a faster decline in demand for labor. Not so fast.

This employment report underscores the US economic resilience we discuss in our **Wealth Outlook 2024**. Despite the fastest rate hiking since the Fed started announcing targets the US economy has been remarkably resilient. There have been several reasons for this. The bulk of the initial recovery from the pandemic was built on fiscal stimulus. During this time, the private sector did not "overbuild." It "under-hired." Subsequently, as stimulus was reduced, there was strong pent-up demand, particularly for services labor. While inflation harms incomes, receding inflation is reducing this harm."

In our **Wealth Outlook 2024**, we argue that "rolling recessions" have impacted cyclical industries and corporate profits over the past year. Rolling areas of weakness will continue, but all are likely to "roll out" within the year to come. In 2024, we expect falling inflation and a turn in Fed policy will set the stage for an improved market environment that will anticipate faster growth later in 2024.

Timing of the Fed Pivot

The Fed is going to wait until the labor market cools before it begins to make meaningful rate cuts. The fact that core inflation surged and fell over the past two years due to supply and demand imbalances, as well as much higher ambient interest rates, is its primary concern *for now*.

We expect the US Federal Reserve to lower rates at the short end as it sees employment harmed by the lagged effects of its tightening actions. If unemployment rises more quickly than expected, the Fed will also react faster by lowering rates more quickly.

Labor demand has done nothing but grow in the past few years, though that demand is slowing. But wages have not been a major inflation driver relative to supply chain pressures (see **Figure 1**). Core inflation has diminished in 2022-2023 without an outright loss in employment. We see there has been no correlation between the unemployment rate and the rate of inflation over the past couple of years, using the Fed's preferred measure, suggesting the Fed does not need to sacrifice the economy (see **Figure 2**). As we can see in **Figure 2**, in 2020 (dark blue dots) the unemployment rate rose rapidly as the country shut down for covid, but initially inflation actually fell. Then in the reopening period of 2021 and 2022 (light blue dots) the unemployment rate dropped rapidly, and inflation surged looking like a classic overheating economy. But instead of requiring a radical loss in employment 2023 (red dots), has shown rapid decreases in inflation with no increase in unemployment.

Figure 1 Global Supply Chain Pressure Index vs US CPI Goods Y/Y%

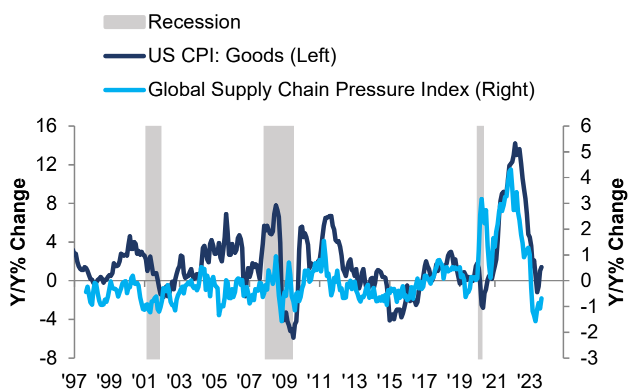
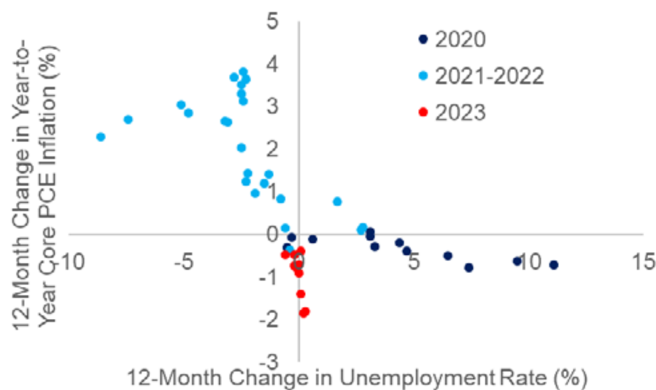


Figure 2 Change in US Core Inflation vs Change in Unemployment Rate (%)



Source: Haver Analytics as of December 8, 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.

It's "Good" When Supply Meets Demand at a High Level

We see inflation running at 2.5% by the end of 2024 with 10-year rates in a range between 3.5% to 4.0% at that time. Following this period of falling inflation and rates, we expect the growth rate of production and capital investment to improve and consumer spending to firm heading into 2025.

When supply and demand meet at a high level as inflation is falling, there is no need to crush the economy and labor markets to bring down inflation. The Fed will likely make this observation and it is one of the key reasons why financial markets have responded positively to reports showing inflation is slowing over the past few months.

But we have little doubt that US employment gains will continue to slow. While there were some strong segment gains in November, only 52% of private industries – barely a majority – added headcount (see **Figure 3**). As of October, the level of unfilled job openings has fallen by 3.3 million after peaking in March 2022.

While some might anguish over the 0.4% monthly gain in US wages in November, most data show the Fed is handily winning the inflation fight with its patience and persistence (see **Figure 4**).

As we note in our **Wealth Outlook 2024**, some new supply shock remains among the biggest potential "spoilers" for our base case. When supply shocks have occurred – the most acute of which were seen in 2020, at the start of the 1970s, and the start of the 1980s – higher prices coincided with weak labor markets. But barring some loss of supply, we believe greater equilibrium between supply and demand is being restored in the world economy, and that's good news for all.

Figure 3: Share of private Industries with rising employment

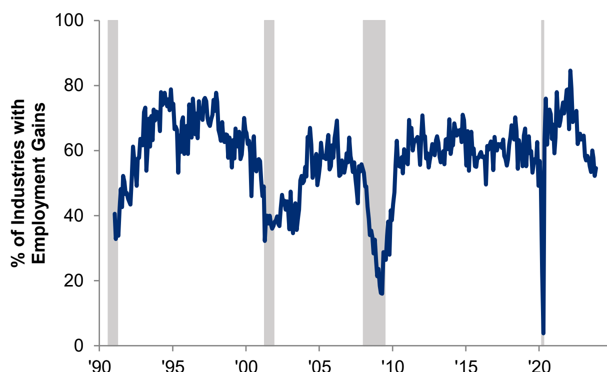
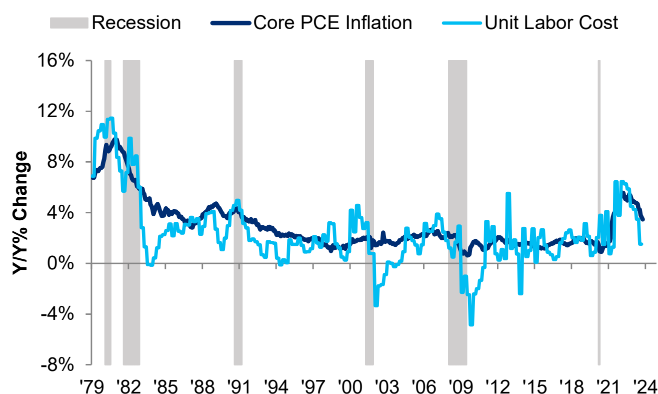


Figure 4: Unit Labor Costs and Core Inflation Y/Y%



Source: Haver Analytics as of December 8, 2023. Grey areas are periods of recession. 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.

Labor markets are poised to slow, stemming US rate pressures

We remain convinced that a slowing in US employment in 2024 is likely. Job gains in 2022-2023 exceeded GDP gains by the most since 1974. However, we believe this period of falling productivity – another anomaly from the pandemic era's strange swings in demand and labor composition – is likely coming to an end.

The US labor market is far more cyclical than most developed market economies, with relatively low barriers to hiring and firing. Consequently, US monetary policy is also much more variable, constantly reacting to the state of employment. It is notable that since 1980 (when the Fed started taking more responsibility for controlling inflation), the Fed has begun cutting rates with US employment averaging gains of 146,000 per month for the half-year before.

This is one of the reasons the Federal Open Market Committee (FOMC) participants forecast two rate cuts as a median estimate in 2024. (FOMC members will provide an to update these forecasts this week).

Remain in Balance

We believe that balanced portfolios have the potential for stronger performance over the next decade than has been experienced for some time. Diversification may also diversify portfolios from security concerns and unpredictable election results – two impending risks.

Bond yields have tripled from their lows. For example, investment grade corporate debt yields, even those with low durations, sat at 6% as of November 16, 2023. If inflation were to end 2024 at our expected level of 2.5%, real corporate bond yields would be approximately 3.5%.

The evolving macro environment also suggests that equity price appreciation will broaden in the US, then globally. The largest US tech-related shares (the "Magnificent 7"[1]) have driven the majority of returns in global equities in 2023. For 2024, we expect that profitable small- and mid-cap growth shares with solid balance sheets will see renewed interest.

A prospective improvement in corporate profits led us this past October to raise the equities allocation in our core portfolios to overweight from neutral for the first time since 2020. For now, the overweight is 2% and mostly centered on the US – but we suspect we're being conservative. If the US dollar weakens along with falling interest rates and credit stays firm, as we expect, equity returns could be significantly stronger and broader than we currently anticipate. This would suggest a higher global equity overweight if key conditions are met.

[1] The Magnificent Seven stocks: Amazon.com (AMZN), Apple (AAPL), Google parent Alphabet (GOOGL), Meta Platforms (META), Microsoft (MSFT), Nvidia (NVDA) and Tesla (TSLA).

Read last week's CIO Bulletin for more on our views going into 2024: 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[2]. 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.

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

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High quality (very strong)	Aa	AA	AA
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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