Market and Economic Commentary

2024 Outlook

A Fork in the Road- Where Do We Go From Here?

While we are on the tail end of the rate cycle, the market will continue to gyrate around two questions. When will the Fed cut rates, and how many times will the Fed cut rates. A few weeks ago, shifting of bulls gave upwards of a 90% chance of rate cuts in March and 6 rate cuts. With the past 2 weeks of data releases, that hope has dwindled to 49%, which still seems overly optimistic. We have hit a fork in the road that will determine how the year plays out.

The first path is a soft landing with the Fed easing rates because they can and not because they have to. This has quickly evolved from what seemed like a pipe dream into what many hope is a self-fulfilling outcome. The US consumer stays strong, the job market stops cooling, unemployment remains low, and TCU wins the NCAA tourney. Not asking for much, right? This path may ultimately lead to a smoother course, however it will extend the time until we see the Fed cut rates. Added pressure on valuations and earnings in the equity market, a growth scare in Q1 is a real possibility if we stay higher for longer. From there, the Fed must perfectly time cuts. Cut too soon, and the economy gets hot and inflation returns front and center. Cut too late and the economy falls into a recession. Sounds easy, right? You got this Jerome!

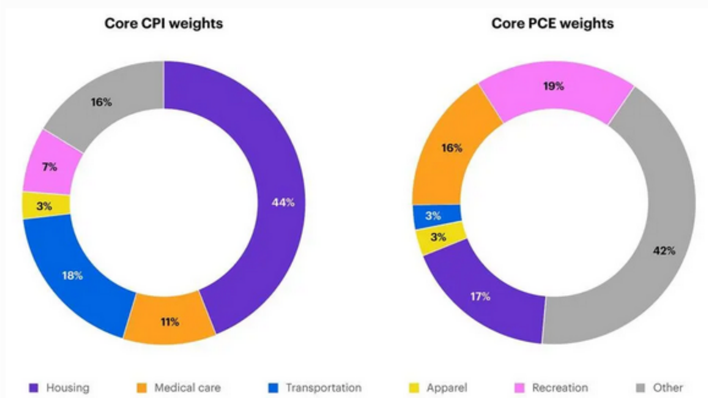
The second path is the economy takes a downturn and veers toward a recession. In this path, the cracks we are beginning to see, especially in the US consumer, break. This will cause the Fed to have to cut rates in an effort to spur economic growth. It will lead to cuts happening sooner and more frequently. If you view a failing consumer as a tailwind with already seemingly sustained inflation, perhaps the Fed finally has an ability to cut sooner rather than later without nearly the risk of inflation returning. Currently, the signs point to the recession being shallower and further out.

While the media focuses on a soft landing and happy ending, we will explore how the interpretation of data demonstrates while a soft landing is possible, a lot of things must go right. We must be clear that it has not become our base case outcome but rather remains the best case.

Can We Stop Talking about Inflation Already?

Almost, but no. The good news is core PCE continues to drop posting a .2% increase in December and 2.9% increase year over year. This comes 2 weeks after news broke a week prior with core CPI coming in higher than expectations at 3.93%. If I had a nickel for every time I see core CPI used in market commentary and headlines as the say all be all to inflation, I would be able to fully fund both my children's college funds. Let's dig into why the wedge has grown and why despite intense media coverage, core CPI has become nothing more than second tier data.

The weightings and calculations that go into the 2 indexes differ vastly. As illustrated, core CPI weights shelter at 44% while core PCE was just 17%. Considering shelter costs rose .5% in December, this makes a material difference. In terms of different calculations, medical care is a prime example. Core PCE excludes payments made by employers and insurance whereas core CPI does not, further attributing to the wedge. In December, core PCE medical care costs rose .14% while core CPI attributed 0.7%.



SOURCE: BUREAU OF ECONOMIC ANALYSIS, US BUREAU OF LABOR STATISTICS, MORGAN STANLEY WEALTH MANAGEMENT ... [+] SOURCE: BUREAU OF ECONOMIC ANALYSIS, US BUREAU OF LABOR STATISTICS, MORGAN STANLEY WEALTH MANAGEMENT MARKET RESEARCH & STRATEGY, BASED ON AUGUST 2022 DATA.

When Will the Fed Hit Their 2% Target?

After their last meeting of 2023, the Fed predicted that we will reach 2% in 2026. However, it wouldn't be surprising if we hit 2% as early as June. Even more encouraging is the fact that PCE fell to 1.5% on a three-month annualized basis in Q4, its lowest since June of 2020. Viewing on an annualized 6 month basis, it was 1.9% for a second month in a row. The final 1% is absolutely the hardest, but the data suggests we may have already hit that point beginning in June of last year. As the remaining large numbers from January through May 2023 are replaced with smaller (hopefully) numbers, the case for a quicker path to 2% is stronger. Whether or not this means the Fed will cut rates is clear- the Fed will cut rates in 2024. The questions we are asking now is when will cuts begin and how many times will it happen.

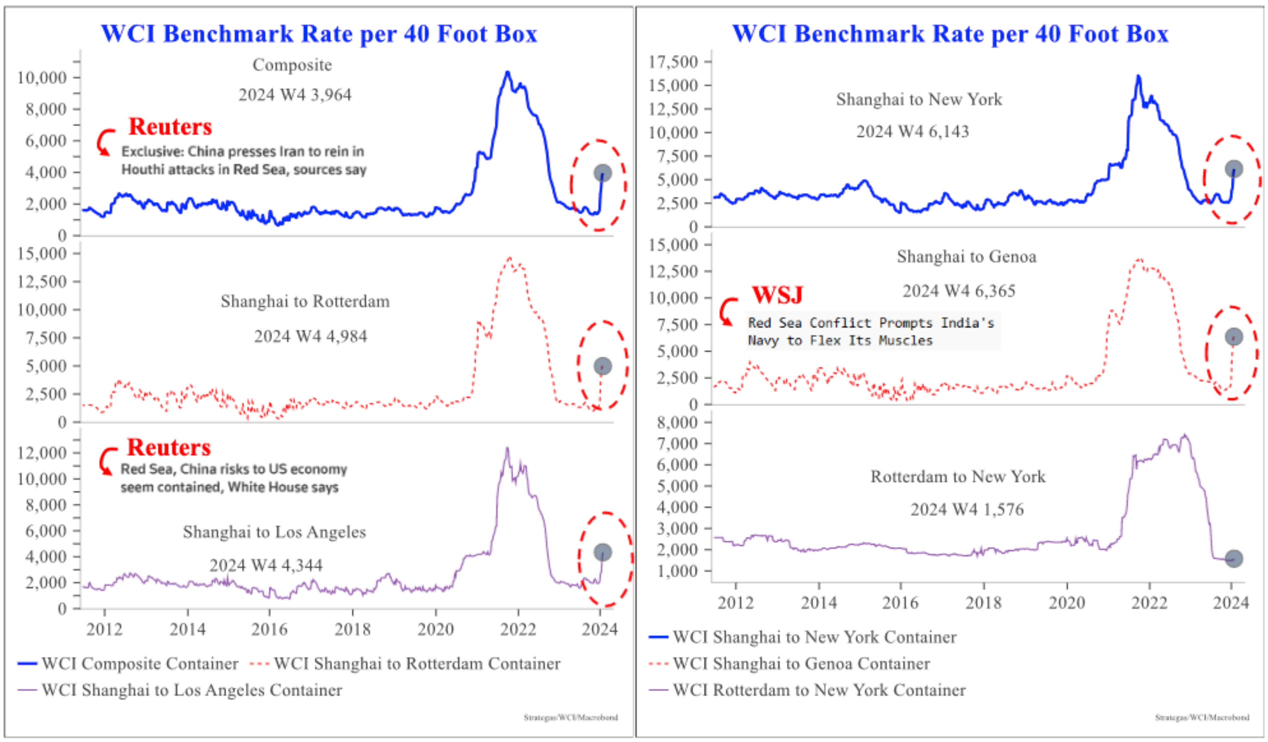
2023 vs. 2024 Estimated PCE

Month	2023 PCE	2024 Est.	YoY Delta
January	0.5	*0.2*	-0.3
February	0.4	*0.2*	-0.2
March	0.3	*0.2*	-0.1
April	0.3	*0.2*	-0.1
May	0.3	*0.2*	-0.1
June	0.2	*0.2*	0
July	0.1	*0.2*	0.1
August	0.1	*0.2*	0.1
September	0.3	*0.2*	-0.1
October	0.1	*0.2*	0.1
November	0.1	*0.2*	0.1
December	0.2	*0.2*	0
YOY Change	2.9	2.4	-0.5

Source: Bureau of Labor Statistics

Geopolitics Raising Concerns to Inflation

Tensions in the Middle East are delivering another shock to global trade. Houthi rebels from Yemen have begun attacking cargo ships in the Red Sea in an effort to stop Israel's offensive against the Hamas in Gaza. This has escalated with Houthi rebels firing a missile at a US warship. As a result of the conflict, ships are having to go around Africa's cape rather than using the Suez Canal. While the White House believes the economic impact to the US is somewhat contained, it does pose a real threat to inflation as global shipping costs have spiked and supply delays. While everything seems set for rate cuts to happen in March, it would not be wise for the Fed to make a March cut without monitoring the situation. It stands to be mindful that higher freight rates led to inflation in 2021.



The State of the US Economy

This week, we saw real GDP surprise substantially, growing at a pace of 3.3% if annualized, far exceeding the estimates of 1.7%. It should be noted however, that at the end of Q3, the annualized rate of growth was 4.9% showing a contraction quarter over quarter. For a 12 month roll, real GDP increased 2.5% in 2023. This should only further the case that the economy currently not showing signs of turning negative and diving into a recession soon, right?

Everyone should be reminded that it always looks like it will be a soft landing until it isn't. With the economy chugging along, cracks are beginning to show in the sustainability of growth. There are some flaws with over interpreting the real GDP figures we have been seeing. The most prominent cracks discussed are the US Consumer losing its resiliency and the Commercial Real Estate market's affect on banks. The biggest driver in GDP is the US consumer. Private consumption accounts for 65-70% of GDP. While the US consumer remains vigilant to continue to spend, the US balance sheet shows inflated resiliency. Additionally, there may be some flaws in how GDP is being portrayed adding a second threat to continued economic growth.

Resilient Real GDP Confidence has Been Inflated- By Inflation

There is no arguing the surprising resilience of the US economy. It is interesting to look at the affect inflation has had when comparing Real GDP (taking inflation into account) to nominal GDP. While inflation was highest, negative Real GDP figures could be attributed to inflation while narrowly missing a recession during the growth scare of 2022. What looked like a recovery with 2022 Q3 real GDP, we saw Nominal GDP continue to decline for 5 straight quarters. However, in 2023 Q3, we got a surprising boost in both Real and Nominal GDP thanks to a jump in consumer and government spending. So while positive, the Q4 number is a drop from the Q3 boost rather than a sign the economy has recovered. Worth noting, it takes over 12 months for hikes to ripple through the economy and the 400 bps of hikes from June 2022- Dec. 2022 are just now being felt. The additional 100 bps from the first half of 2023 have not been fully realized.

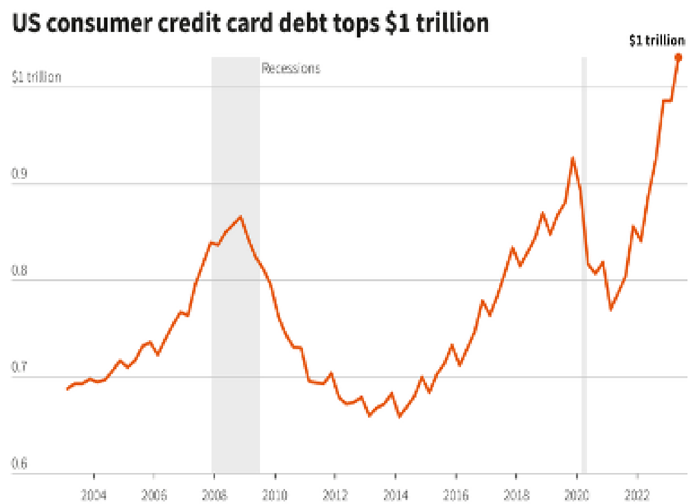
Differences Between Nominal and Real GDP

Quarter	Nominal GDP (Annualized)	Real GDP (Annualized)	Effect of Inflation
2022 Q1	6.08%	-2.00%	8.08%
2022 Q2	8.24%	-0.60%	8.84%
2022 Q3	7.04%	2.70%	4.34%
2022 Q4	6.36%	2.60%	3.76%
2023 Q1	6.12%	2.20%	3.92%
2023 Q2	3.72%	2.10%	1.62%
2023 Q3	8.08%	4.90%	3.18%
2023 Q4	4.36%	3.30%	1.06%

Source: Bureau of Labor Statistics

A Weakening Consumer

With Covid relief measures having disappeared coupled with high inflation, Americans are readjusting by incurring mounting debt. To end Q3 of 2023, US credit card debt left unpaid ballooned to $1.079 trillion with 2.98% delinquent. This is the highest since 2008 (peaked at 6.77%). This argues the point of whether the 2023 Q3 Real GDP spike was sustainable or a result of reckless spending. With higher variable rates, the amount of and number of delinquencies will likely increase. Further evidence is seen with auto loans. Car loan defaults over 60 days late have also climbed above 6% on subprime, marking the highest level we have seen since Fitch began measuring in 1996. Despite low unemployment, the reality is the US consumer as a whole is over leveraged.

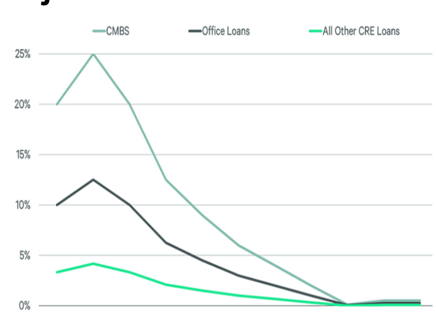


Source: Federal Reserve Bank of New York | Reuters, Aug. 8, 2023

Is it Doomsday for CRE?

Nearly $350B in commercial real estate notes issued by banks are maturing. With property values dipping due to higher cap rates combined with higher vacancy, the shift to working from home has put a particular strain on office spaces. Fortunately, this accounts for 18% of all maturing CRE bank loans maturing. A larger amount of losses will apply to Commercial Mortgage Backed securities, particularly in the sub prime tranches. While these losses will be significant in lower tranche Commercial Mortgage Backed Securities and office space, an all out crash in CRE isn't as likely as we've been led to believe. This furthers hope for a shallow recession.

Projected Loan Loss Rates



Source: CBRE Research, July 2023.

Do We Forget about the Inverted Yield Curve?

In 2022, we were graced with an inverted yield curve that still exists today. Yield curves invert as the expectations for longer rates are lower than expectations of short term rates. The most common comparison is the 2 and 10 year treasuries seen below where for over the past 19 months, the 2 year has yielded more than the 10 year. We were flooded with headlines saying an inverted curve is always a predictor of a recession. To be clear, it does not *always* predict a recession as 1966 proves to be the exception of the theory. But is 1966 really an exception? The market returned -20% and GDP went from 10.1% in Q1 down to 0.2% in 5 quarters. Technically not a recession but growth came to a standstill. After minuscule growth followed, a second inversion occurred 2 years later and you guessed it, shallow recession ensued in 1969. Fast forward to today, if you search “yield curve inversion” we are flooded with articles supporting why the inversion is no longer a valid predictor.

Source: Federal Reserve of Economic Data

Is the Inversion Just Coincidence?

The yield curve inverting is really just a product of the rate cycle. When tightening begins due to the onset of substantial rate hikes, yield curves invert. When policy eases with the onset of rate cuts, yield curves normalize. What is interesting is the timing of the inversion and normalization that can provide some insight into why inversions are revered for their “predictive power”. The average duration for yield curve inversion lasts for 7 months. The average time for the onset of recession to appear after inversion is around 12-15 months (and officially being termed a recession in 18-24 months. What this does is display is how long it takes for quantitative tightening and easing alike, to be felt in the economy, which happens to be around 12 months.

So what can we gather from this?

There is no coincidence. Yield curve inversion isn’t a predictor it’s a product of a rate cycle. The delayed ripple effects of rate hikes is why it always looks like a soft landing until it isn’t. The sooner the Fed cuts rates the better because it is all about how bad it will be in between. If we see cuts in June of 2024, we won’t fully realize the easing until 2025 making current growth estimates overstated and optimistic. This reminds us that a recession is still a real possibility of coming in the distant, not so distant, not so near, near future. It currently looks to be a shorter and shallow one. The Fed Funds rate will likely end in the 2.5-3.5% range (goodbye 0%), and this “pain” ahead will provide a more balanced policy as opposed to the care free “QE Infinity” days of the “roarin’ 10's.”

Market Commentary

2023 The Year of the "Magnificent 7"?

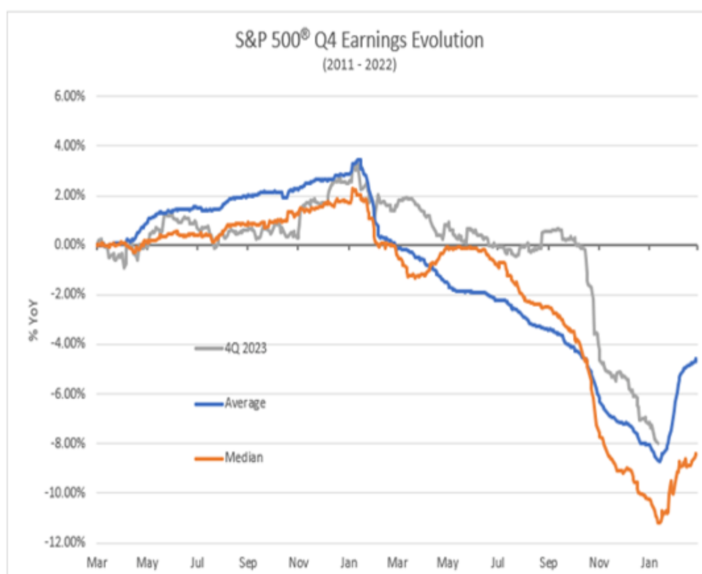
We saw a large portion of performance contributed by what is now dubbed the "Magnificent 7" (Microsoft, Apple, Nvdia, Alphabet, Meta, Amazon, and Tesla). They rallied back from steep losses in 2022 (a combined -46%) contributing 60% of the S&P 500 index's 24% 2023 return. Conceptually, it is important to note that the outsized contribution led to these names making up 29% of the index's allocation. While they did contribute to a lion's share, the weighting proportions matter.

The bigger story should be how the breadth of the market began to expand in the summer with broad participation rather than being just "7 names". This is evidenced by the fact the at the end of Q2 in 2023, the Magnificent 7 had contributed to over 74% of the market's performance. The chart below shows us narrowing again as earnings roll out, but that doesn't necessarily mean the big names will do all the heavy lifting in 2024 either.

Source- MacroMicro.me

Speaking of Earnings…

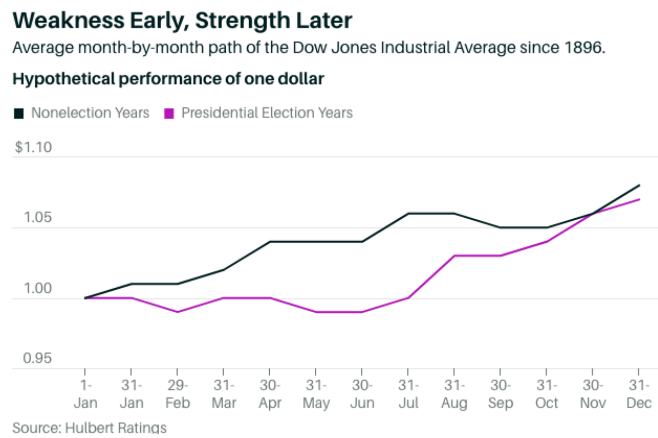
With nearly 25% of companies reporting actual results, you will see headlines littered with earnings beats. In fact, 69% of the companies that have reported had positive surprises. Historically, earnings estimates get revised down as we head into 4th quarter earnings season. This is referred to as the fishhook. This time, it took longer, but eventually followed the trend with revisions netting out -6.9% the past quarter. The surprises haven't been big for the most part, with the blended year-over-year earnings growth for the S&P 500 currently estimated at -1.4%. While the fishhook effect may allow for this number to be higher, if we finish negative, it will mark the 4th time out of the past 5 quarters the index has reported a year-over-year decline in earnings. The take from this is that while earnings beats are a good thing, we must look at the actual numbers too.



Source: FactSet as of 1/15/24

Does an Election Year Matter?

With it being an election year, historically markets perform well. If you look beyond just end of year returns, a pattern emerges with a correction late Q1, a slow Q2, and a strong rally in the second half as displayed in the chart of the Dow during election years. Despite the current environment we find ourselves in being anything but normal, the same may very well hold true this year. To gauge the current outlook, we will discuss valuations, the potential for a growth scare, and support for a strong second half. Oh, and you guessed it, the Magnificent ~~7~~ 6.



Is the S&P 500 Overvalued?

On the surface the S&P 500 looks overvalued. Based on 2024 estimates, the current forward price/earnings ratio at 20.0x, above both the 5 year average of 18.9, and the 10 year average of 17.6, and the long-term average of 15.9. When removing the Magnificent 7's valuations, the remaining 493 are sitting at a 15.5x multiple, showing a slightly oversold market.

Conversely, those big 7 names are currently at a 35x multiple on forward earnings inclusive of 20% estimated earnings growth in 2024. Any missteps from the Magnificent 7 and the fall from grace will be swift. Articles post Tesla earnings have removed them from the 7 after posting disappointing results and has tumbled 26% YTD.

Additionally, looking at trailing valuations if earnings growth expectations retreat to 0, the lack of first half breadth has left value style boxes cheap.

VALUATIONS*
(CURRENT P/E VS. 20-YEAR AVERAGE)

	Value	Blend	Growth
Large	11.2x	15.1x	26.8x
	13.3x	*15.2x*	*20.3x*
Mid	11.5x	14.2x	22.9x
	14.8x	16.3x	*20.9x*
Small	13.6x	15.8x	22.9x
	15.7x	*16.8x*	*21.2x*

Style and market-cap valuations show current valuation on top and 20-year average valuations below in italics.

Source- AllianceBernstein

Is a Growth Scare on the Horizon?

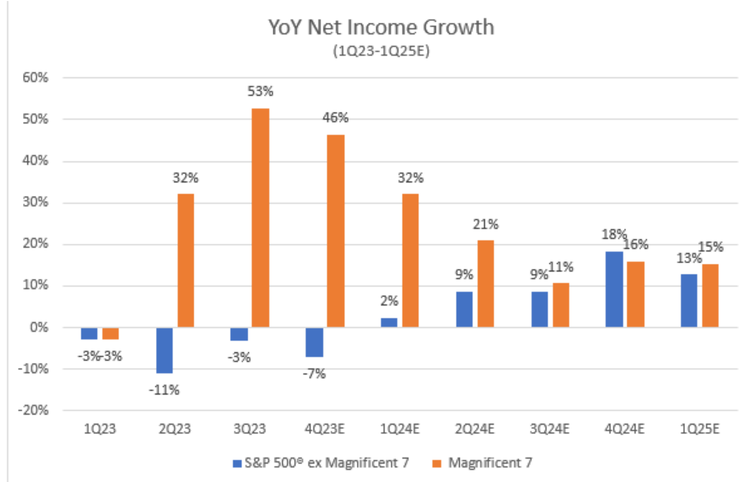
All of this could very well lead to a growth scare and cause the market to swiftly correct in the tail end of Q1. Earnings are expected to grow at an annualized pace of 11.9% so the bar is set high to start the year. The market has also seemingly priced in 6 rate cuts at 25 bps a pop contributing to estimates of growth. This especially comes in context for the Magnificent 7's lofty earnings growth expectations that are largely based on such cuts. Amazon and Alphabet's announcements of laying off thousands of workers might be a sign that measures are being taken to try to continue to hit the high expections.

The timetable and outcome for the first half will largely hinge on a hyper focus on the high bar for the Magnificent 7, the Fed's decision for a March rate cut, and geopolitical tensions in the Middle East. We will get some of these answers this week. We see 5 of the remaining 6 "magnificents" reporting earnings on Tuesday and Thursday with Nvdia not reporting until February 21. If we see big surprises, a correction could be averted or delayed. If we see some disappoint, it could move up the time table.

This week employment and wage data will be released but the biggest weight on the Fed's decision likely will involve if those numbers are deteriorating and the state of geopolitical tensions. If tensions continue to escalate in the Red Sea causing supply chain issues in the Suez Canal, the threat to inflation could very well cause the pause to continue. This could ripple into downward earnings revisions accelerating the timeline and increasing pressure. Ultimately, Jerome Powell is the most important person in the room for 2024.

Sounds Bleak, Why a Strong Second Half?

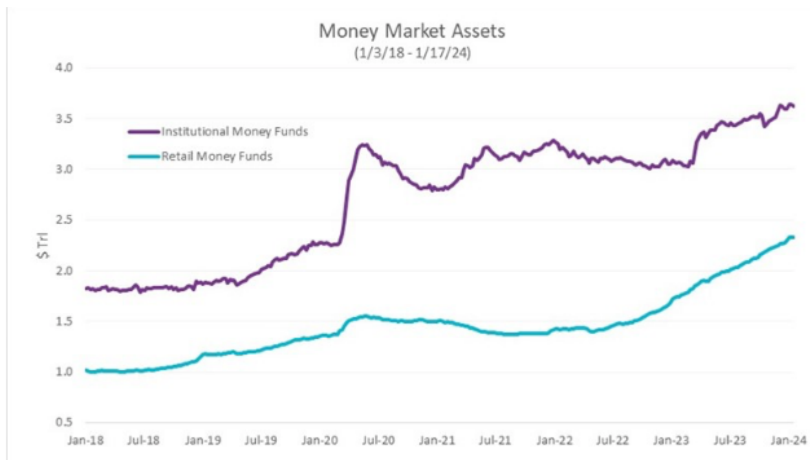
With their current valuation levels below average and the high single digit 2023 return of the S&P 500 ex. Magnificent 7, the stage is set for a broad recovery down the road. Additionally, the reliance on the strength of the Magnificent 7 AI boom is waning. YoY Net Income gaps will close sharply come the second half of the year, as illustrated to the right. This might also put pressure on the huge premiums the Magnificent 7 are currently boasting. While performance has re-narrowed to start the year, a return of the expansion we saw to end last year at a meaningfully higher magnitude is very much on the table. This will lead to broadening diversification.



Source: Bloomberg as of 1/15/24.

A Boost from FOMO

Money market funds remain at all-time highs. There is over $5.9T in retail and institutional money market funds. When the Fed cuts, the 5% yields many have grown accustomed to will drop fast. Short term bond yields move downward quicker than the rate cuts themselves, pressuring yields to move lower swiftly. While not all is expected to go straight into equities, our friend FOMO (Fear Of Missing Out) will undoubtedly come back. If a correction occurs, flows into equities should increase. If we avert a scare and markets grind higher, performance anxiety will grow with diminishing returns in money markets, furthering the case for a strong inflows.



Source: Bloomberg

A Note On Fixed Income

The bond environment is nearing the tailwinds of the most aggressive rate hike cycle in decades. We saw swift repricing in bonds as we have gained by extending duration in October. This should only be a sign of how quickly bonds can reprice but not necessarily a sigh of relief that swings in price movement won't continue. Yields will gyrate back and forth, much as they have to start the year, as they await more Fed decisions. These moves should not be to the scope seen in 2022, but still choppy until Powell cuts. When the Fed does finally cut, there should be strong performance in the fixed income market. If the stock market falters significantly, bond performance could climb even higher as money market funds shift to fixed income more than anticipated. The outlook is very positive once the unwinding begins.

Conclusion

Everything is shaping up to be a potentially volatile yet strong overall year in 2024 with potential for some near term pain for a hopeful long-term gain. The timetable is fluid, a growth scare is not imminent, a rally is not guaranteed, but at some point we will put this long 2 years behinds us. A shallow recession is still very much a base case but remember, markets always peak before the onset of a recession and recover before the recession is over.

With markets creating new all-time highs to start the year, it is not a bearish signal but rather a long-term bullish sign. Small caps continue to lag in recovering showing the potential for strong performance as the Russell 2000 still sits over 19% below their 2022 all time high. This view does come with additional potential risk and volatility in the near- term. In the large cap arena, it will come down to continued focus on individual names and how the data continues to unfold. Focus on both quality and secular growth remains prudent as we start the year while not trying to chase returns.

A Final Note

All of the above is predicated on major unpredictable events not transpiring. Inflation could be driven back higher if a large natural disaster affects supply chain. Increasing geopolitical tensions could harbor the potential for greater volatility.

Let's hope for fewer wrenches thrown at us this year, but overall, positioning is reflective of the risks ahead. There is balance between not banking on a best case soft landing nor anticipating a worst case deep recession. Staying in the middle remains the focus.

Thank you for your continued trust in Paragon and I look forward to another year in the books!