Mitch on the Markets

Portfolio Manager Investing Insights

4 Factors that Should Stay on Investor Radars in 2024

2023 was quite the year. At its outset, 100% of economists were predicting that the U.S. would enter a recession. I floated the possibility that the U.S. could skirt recession but felt that the most likely outcome would be a very mild, shallow contraction.

The U.S. economy defied all expectations and grew all year, and the stock market responded in kind with strong double-digit gains for the year. But 2023 was far from a smooth and easy ride. A regional banking crisis sparked fears of a broader financial contagion, debt ceiling drama weighed on sentiment and markets, sharply rising interest rates triggered a market correction, and another war broke out. There were plenty of bricks in the wall of worry trying to throw investors off course, but patience and a steady hand paid off.[1]

With one day left in the year, it's time for investors to look ahead and think about what factors should be tracked when assessing the economic and market environment. Below I give you four.

ABOUT MITCH ZACKS

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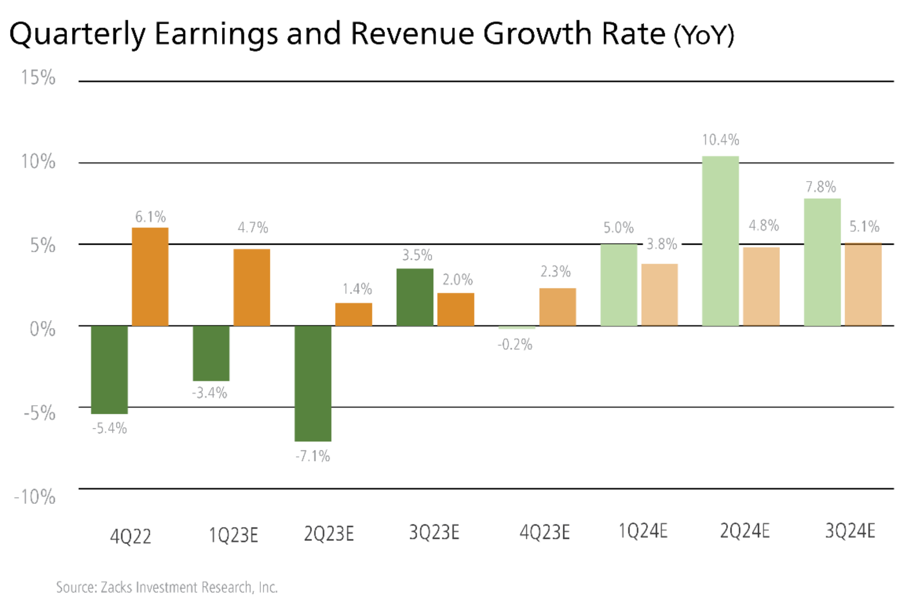
1. **An Earnings Rebound, But Will It Be Enough?**

Though spending has been strong in Q4 and the economy is expected to expand at a solid pace, earnings estimates have been steadily coming down in recent weeks (see chart below). These revised estimates are bigger on the downside compared to what we had seen in the comparable periods for either of the preceding two quarters and also mark a reversal from the favorable revisions we were seeing earlier in the year – something to keep an eye on. Total S&P 500 earnings are now expected to be -0.2% below the year-earlier period, on +2.3% higher revenues.

Source: Zacks Investment Research[2]

As you can see in the chart below, the Q4 earnings dip is expected to be temporary, with compelling earnings rebound playing out in 2024. The key for investors to watch is whether corporations live up to these expectations, and how estimates get revised over the course of the year. Markets like "better than expected."



Source: Zacks Investment Research[2]

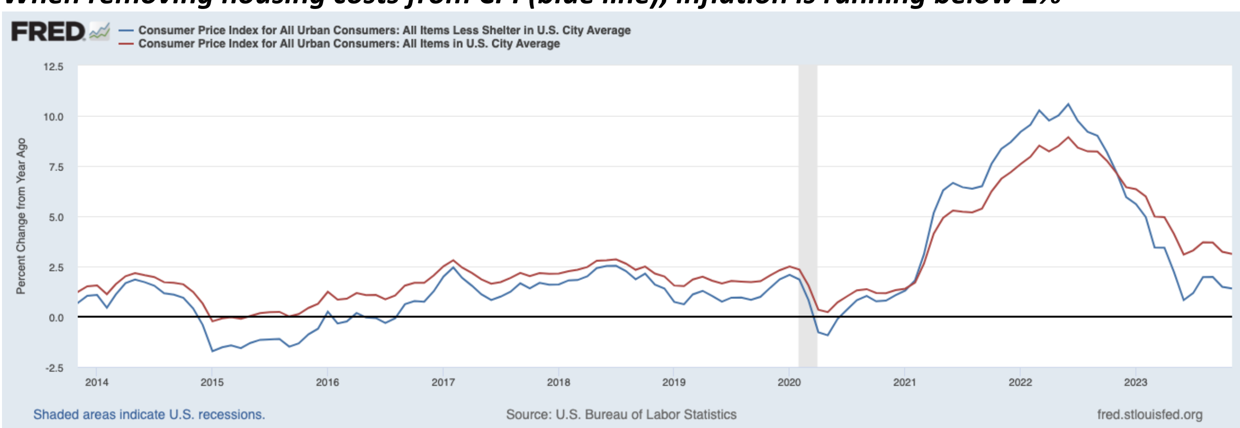
2. Inflation's Last Mile

The November PCE Price Index (the Fed's preferred inflation gauge) came in at 2.6% year-over-year, signaling that progress on inflation continues but still has a bit more to go. Where could the final down-leg of inflation come from? Housing costs.

About 75% of all the year-on-year change in inflation (measured by CPI) has come from U.S. shelter prices. Most readers are aware of rising home prices over the past few years, which has fed into a higher 'owner's equivalent rent' number for inflation. But a quirk in the inflation calculation also factors in new and existing leases, the latter of which has experienced acute price pressures. New leases have seen significant softening, however, with rent growth declining to 3.3% through November, according to Zillow. That's lower than the average rent increases in the two years preceding the pandemic.

The next chart shows why housing costs are so important. If you look at CPI minus the shelter component, inflation went up a meager 1.4% year-over-year in November, which is below the Fed's target.

When removing housing costs from CPI (blue line), inflation is running below 2%



Source: Federal Reserve Bank of St. Louis[3]

I expect inflation to continue in the right direction in 2024, but I think it's also worth considering that the inflation rate could settle at a higher level than we've become accustomed to seeing. Think 2.5% to 3% versus 1.5% to 2.5%, which I think could be influenced by the energy transition and industrial policy putting a higher floor on commodities prices, as well as the shifting trend in globalization known as "nearshoring," where countries are moving supply chains closer to home.

3. Economic Growth and Jobs (Looked at Together)

U.S. GDP expanded by 2.2% in Q1, 2.1% in Q2, and 5.2% in Q3, and the economy added an average of 240,000 jobs per month over through November. And, as I write, the Atlanta Federal Reserve's GDPNow forecasting tool is showing 2.7% GDP growth in Q4, which I think is pretty well substantiated in the strong consumer spending data we've seen this holiday season.

The question is not really whether the U.S. economy will grow in Q4, however. It's how fast or slow the economy expands in the new year, and whether strength in the jobs market will continue to ease. The recipe for rate cuts in the new year is if the economy grows modestly or more slowly than expected, while the unemployment rate gradually ticks higher. It's this soft landing that we ideally want to see.

4. Eyeing Stress in the Credit Markets

Anytime interest rates rise quickly, as they did in 2023, it's only a matter of time before pockets of the credit markets start to feel the tightness. A key example that made headlines in 2023 – and appears likely to make even more headlines in the new year – is commercial real estate debt. There's about $4.5 trillion in outstanding commercial real estate debt, with about half of its floating rate, and due to mature in 2025. That means when that debt is up for refinancing, it will be at much higher rates.

About 14% of commercial real estate is in the office sector, which has struggled mightily to recover from the pandemic and the work-from-home/hybrid work movement. I'd expect to see default rates increase in this space in the coming year. The upshot is that I do not think these pockets of weakness and defaults will result in a full-on credit crunch, especially given strong corporate cash flows and the Fed's stance of being ready to lower rates if signs of economic trouble emerge. Still, this will be a factor to watch closely in the new year.

Bottom Line for Investors

My list above is by no means exhaustive. There are geopolitical concerns that could influence capital markets in the new year, a highly anticipated U.S. presidential election, likely another showdown over the debt and deficit spending, and a whole range of unpredictable events and perhaps crises that could serve as headwinds to growth.

But remember that apart from the U.S. presidential election, the stock market endured all of those other things in 2023 and still managed to post very solid double-digit returns. I'm hopeful for more of the same in 2024.

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[1] J.P. Morgan. December 8, 2023. https://www.jpmorgan.com/insights/outlook/market-outlook/five-considerations-for-investors-in-2024

[2] Zacks. December 20, 2023. https://www.zacks.com/commentary/2200741/q4-earnings-loom-what-to-expect

[3] Fred Economic Data. December 12, 2023. https://fred.stlouisfed.org/series/CUSR0000SA0L2#

STEADY INVESTOR WEEK

- **Strength in holiday spending**
- **Inflation approaching the Fed's target**
- **The housing market is heating up**

Holiday Spending Underscores Ongoing Consumer Strength

U.S. consumers didn't hold back when shopping this holiday season. According to Mastercard SpendingPulse, shopping sales between the beginning of November and Christmas Eve climbed 3.1%, which is largely in line with what the National Retail Federation is projecting for the combined November-December shopping period. This data will be released in January, and should be compared to the 3.6% average shopping growth posted between 2010 and 2019, before the pandemic 'skew.' Mastercard's SpendingPulse showed that online sales rose a stout 6.3% while in-person spending was up 2.2%. This data tracks with firm spending data for November, where consumer spending was seen rising 0.2% month-over-month, and personal income rose 0.4%.[1]

Santa Brought Lower Inflation and Higher Stock Prices

A normally closely-watched inflation gauge went under the radar for November, given its release date of the Friday before the Christmas holiday. But it should have made big headlines. The personal-consumption expenditures (PCE) price index, which is the Federal Reserve's preferred inflation gauge, *fell* 0.1% from October to November, the first decline since the pandemic (April 2020). On a year-over-year basis, prices rose 2.6%, which is a stone's throw from the Fed's 2% target. As we've pointed out in this newsletter before, however, it's worth remembering that the Federal Reserve wants 2% *average* inflation over time, which implies that sometimes inflation could technically run above or below the target. Core prices, which exclude food and energy, rose 1.9% on a 6-month annualized basis, which all but confirms the Federal Reserve is indeed done raising interest rates in this cycle. As seen from the chart below, inflation remains firmly locked in a downtrend.[2]

Personal Consumption Expenditures Price Index, Year-over-Year % Change

Source: Federal Reserve Bank of St. Louis[3]

Is the U.S. Housing Market Poised for a Rebound in 2024?

Existing home sales make up most of the U.S. market, and good news arrived in November. Sales were up 0.8% from October to a seasonally adjusted annual rate of 3.82 million, which provides a much-needed boost to the weakest year for sales in over a decade. The upshot is that sales accelerated even as mortgage rates were climbing since the sales logged in November likely went under contract in September or October. Since then, mortgage rates have come down – as of last week, Freddie Mac reported that the average rate on the standard 30-year fixed mortgage was 6.67%, marking the seventh straight week of declines. This is a marked decline from the near 8% mortgage rates logged this fall and could result in more enthusiastic buyers heading into the new year.[4]

[1] AP News. December 26, 2023. https://apnews.com/article/holiday-sales-mastercard-spendingpulse-cc87e571ccffbae39110132a4c39a7c9

[2] Wall Street Journal. December 22, 2023. https://www.wsj.com/economy/what-to-watch-in-fridays-spending-report-inflation-closing-in-on-feds-target-0778037d?mod=djem10point

[3] Fred Economic Data. December 22, 2023. https://fred.stlouisfed.org/series/PCEPI#

[4] Wall Street Journal. December 20, 2023. https://www.wsj.com/economy/housing/housing-heats-back-up-7ffcb282?mod=economy_feat2_housing_pos1

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