Market Commentary
by Chief Market Strategist
Arthur Hogan

FEBRUARY 14, 2024

Q1 2024 OUTLOOK—THE SUN ALSO RISES

After market participants spent the better part of 2023 waiting for a recession that refused to materialize, we entered 2024 with a string of better-than-expected earnings reports and strong economic data. Many of the 2023 headwinds have turned into 2024 tailwinds for markets. The Fed has reached the end of its Monetary policy rate increases and will likely cut rates at some point this year. The U.S. dollar hit a peak last October and has come down gradually of late. Treasury yields have come off the boil, with the ten-year yield peaking at 5% last year, and are now settling into a 4.0-4.3% range.

What The Majority Got Wrong In 2023

Many historical recession signals were thrown into disarray from the pandemic-induced economic shutdown and subsequent aggressive Fiscal and Monetary policy stimulus.

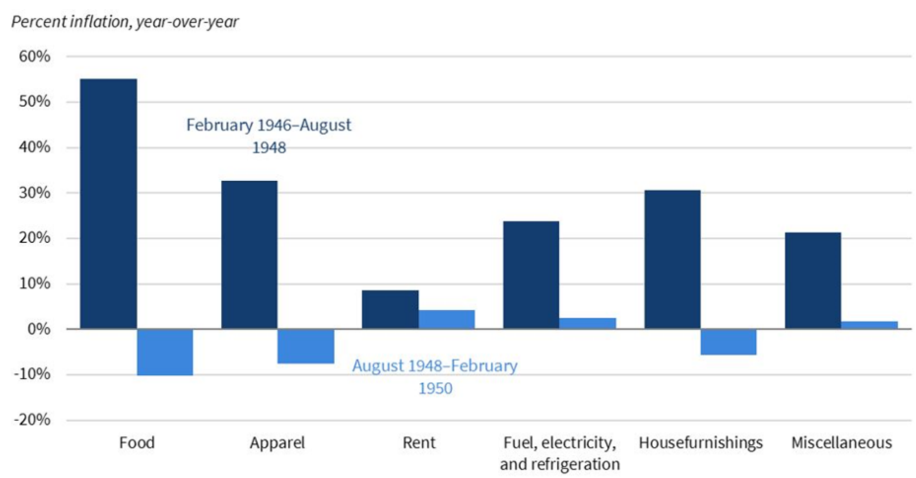
Market scholars put too much weight on "leading indicators." Weighted towards the manufacturing and industrial sectors, these indicators were always going to exaggerate the danger of recession as consumer spending swung from goods to services. U.S. consumers typically spend 65% on services and 35% on goods in any given year. For obvious reasons, we overspent on goods during the pandemic lockdowns and quickly moved to overspending on services once the economy reopened. The bullwhip cycle made a manufacturing recession inevitable after reopening, but services and labor markets stayed resilient.

Chart 2: Big rotations in consumer spending

Source: FRED Economic Data St. Louis Fed

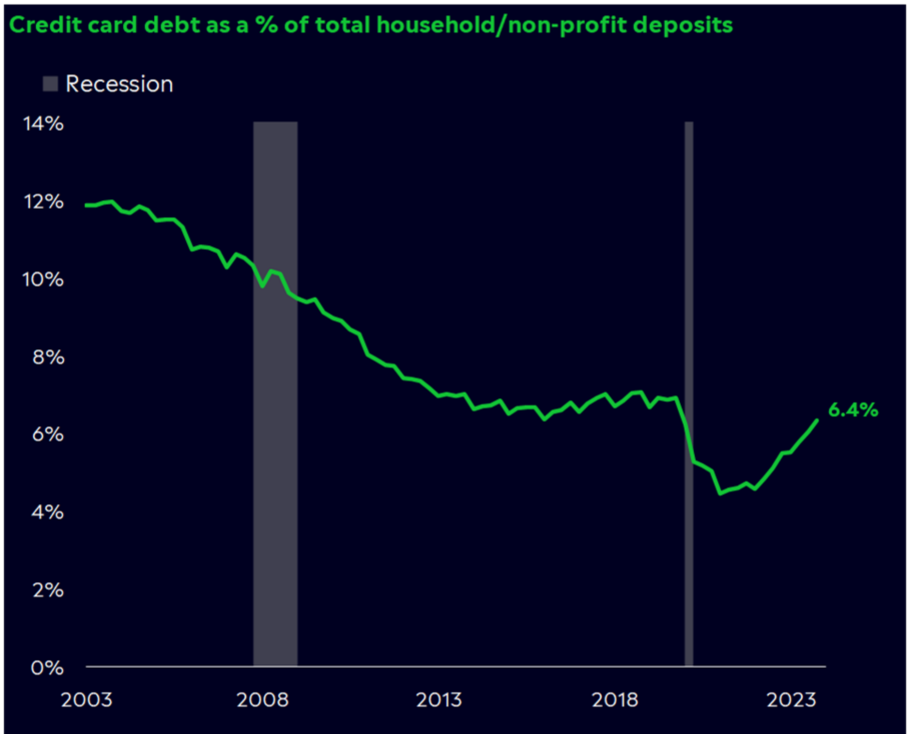
Many confused a one-off shift in the price level with the start of an inflationary spiral. Just because the price pressures became broad-based didn't mean they would persist. The correct historical template was likely the 1940s, especially the transition period after WW2, not the 1970s. Supply shortages and pent-up demand caused the rapid post-war inflationary episode.

Figure 2: Immediately after WWII, inflation surged, then retreated



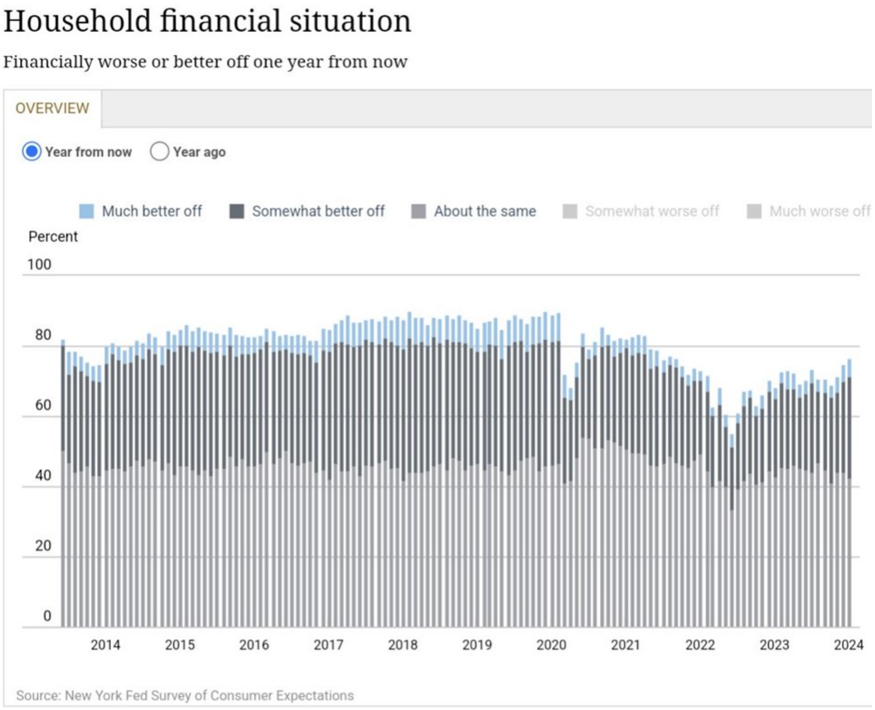
Source: BLS.

Household Balance Sheets Are Strong



Source: eToro, Bloomberg, Federal Reserve

As inflation has come down, real income growth has recovered. This has allowed consumers to keep spending. Recent signs of a reacceleration in the U.S. economy are testimony to the benefits of falling inflation. Falling inflation should be a tailwind for household wallets in 2024. Stronger inflation-adjusted incomes will likely power consumption going forward and, thus, the economy. Plenty of ink has been spilled about the record-high level of consumer debt. Credit card debt is at $1.1 trillion now, but the percentage of credit card debt relative to money in the bank is near the lowest in 20 years.

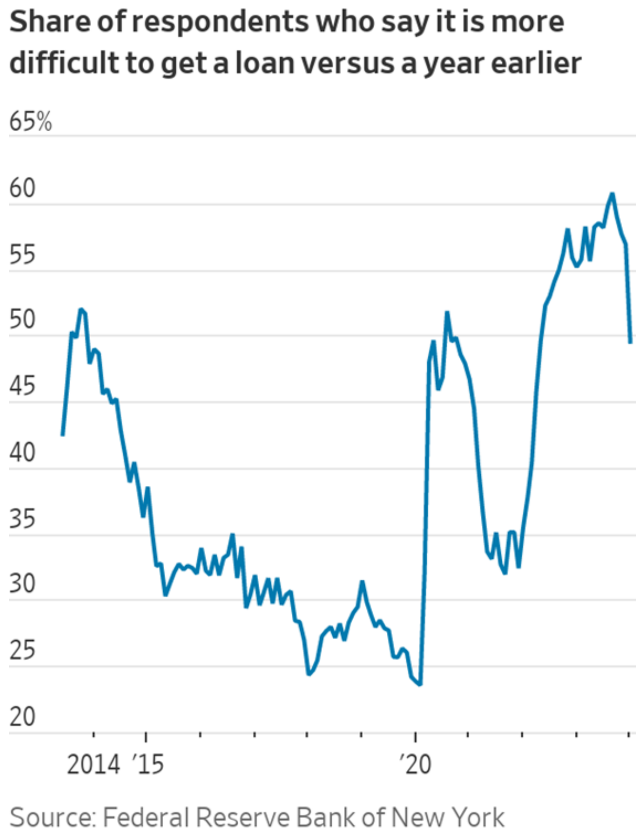


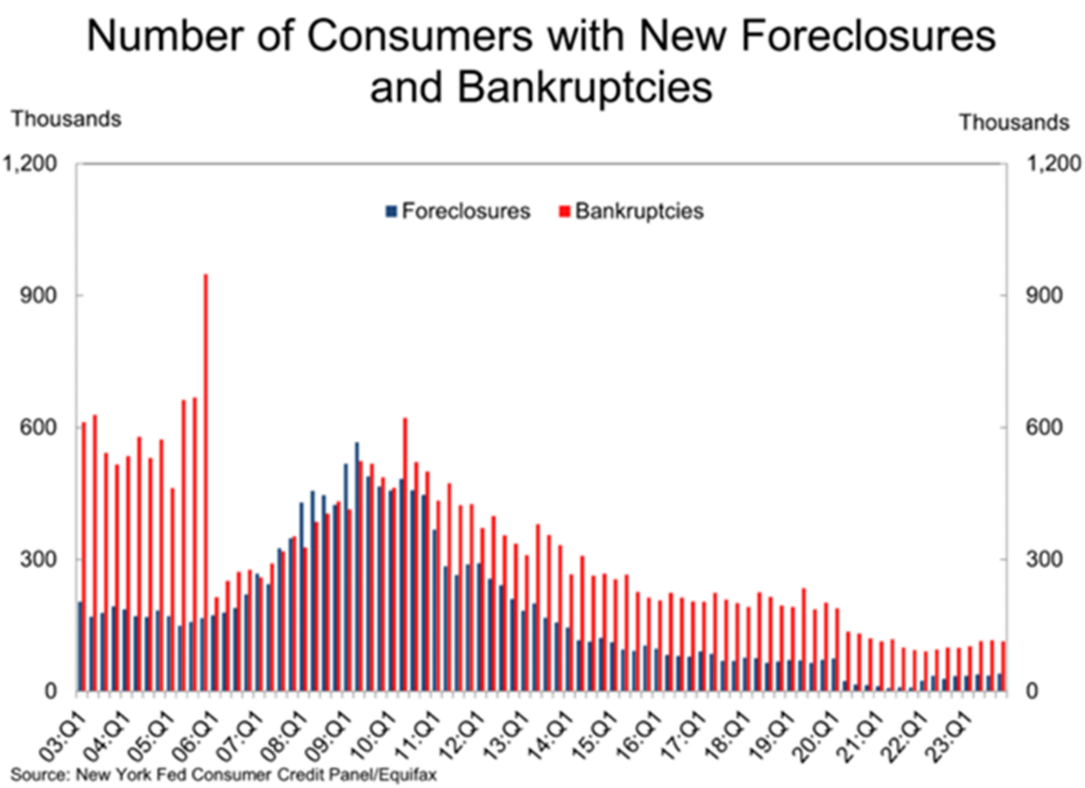
Consumers Remain Confident

Consumption spending makes up two-thirds of the U.S. economy on average, so as the U.S. consumer goes, so goes the U.S. economy. In a recent survey from the Federal Reserve Bank of New York, respondents were upbeat about the future. Of those surveyed, 76.5% expect their financial situation to improve or stay the same over the next year. That is the highest reading since September 2021.

In the same survey, respondents showed that inflation expectations are well grounded, and access to credit is easing. Median inflation expectations were unchanged at the one- and five-year ahead horizons, at 3.0% and 2.5%, respectively, according to the January Survey of Consumer Expectations. Expectations at the three-year-ahead horizon declined to 2.4% from 2.6%. Perceptions of credit access improved notably, with a smaller share of respondents saying it is harder to obtain credit now than it was a year ago and a larger share reporting it is now easier. The share of respondents expecting tighter credit conditions a year from now also declined.

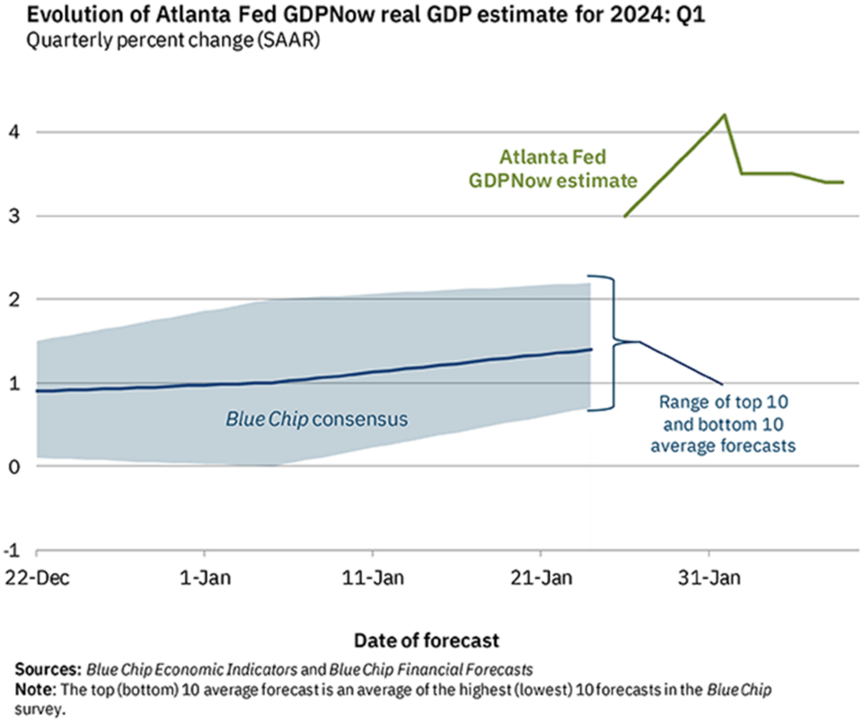
Consumer bankruptcies fell in 4Q to 114,000 from 116,000. This was running above 200,000 in late 2019.





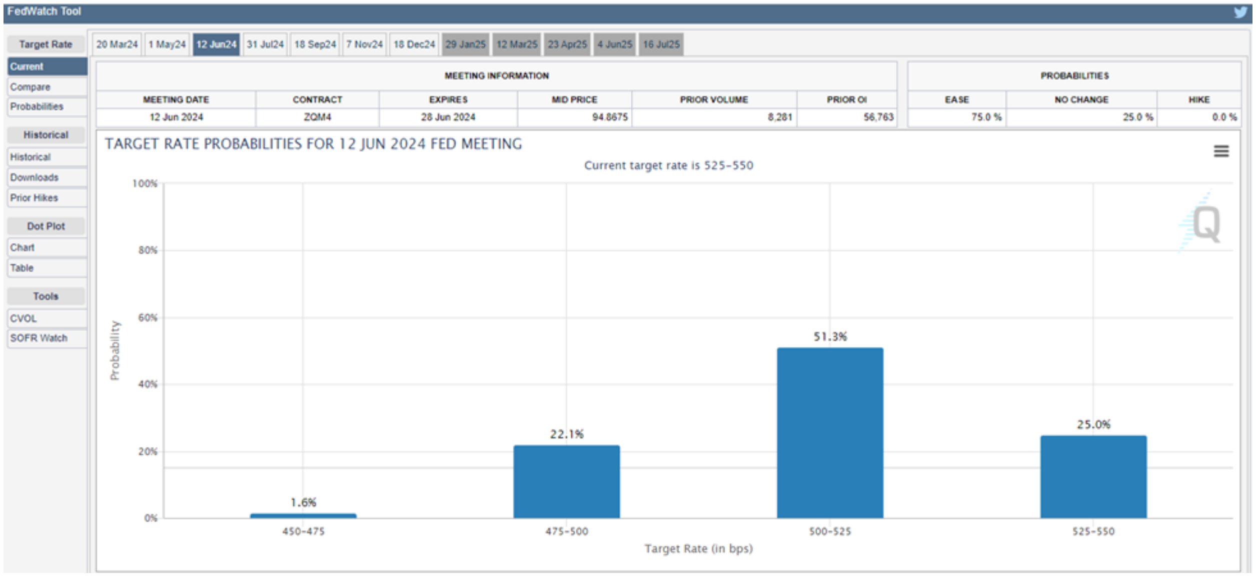
U.S. Economy Is Growing

The Atlanta Fed's GDPNow model estimate for real GDP growth in the first quarter of 2024 is 3.4%. The growth rate of real gross domestic product (GDP) is a key indicator of economic activity, but the official estimate is released with a delay. The GDPNow forecasting model provides a "nowcast" of the official estimate prior to its release by estimating GDP growth using a methodology similar to the one used by the U.S. Bureau of Economic Analysis.



FOMC

One storyline so far this year is that the economy is still performing better than people expected, and for now, it looks like rate cuts will not be as soon or plentiful as people would have thought at the start of the year. The narrative of imminent interest-rate cuts by the Federal Reserve continues to dissipate. The consensus for a March Fed rate cut sits at 8% versus a 50% reading a week ago and an 80% chance at the start of the year, according to the CME FedWatch Tool. The May meeting now shows a 35% chance that we will get a rate cut, and June looks like a coin toss at 51%.



Source: CME FedWatch Tool

We feel it is more important to focus on why the Fed will cut rates instead of when. Many think the Fed cutting rates is a sign we are in or near a recession. It is true that some rate cuts have come during times of economic weakness, even recessions. Many immediately think about 2001, 2007, and 2020 as times the Fed cut to stimulate the economy amid troubles. Some rate cuts take place during what we would call periods of normalization.

A normalizing first cut is a cut that takes place after the Fed hiked to slow things down; the economy slowed but did not fall into a recession and then began to expand again amid lower inflation. Think of this like the first cuts in 1984, 1995, and 2019. Then, of course, there are what we would classify as panic cuts. Think of times like after the 1987 crash, the fall of 1998 during the Russian ruble and Long-Term Capital Management crises, and, of course, March 2020.

The normalization rate cuts would come as the path of inflation continues toward the Fed's 2% target, and they find themselves to be overly restrictive. That is a good rate cut. So, if that does not happen until the second half, we are fine with that.

Outlook

We foresee a path to S&P 500 earnings of $253 in 2024. Using a 21-times trailing multiple on that earnings estimate gets us to a year-end 2024 target of 5300 for the large-cap index. We would overweight small caps as we see a significant chance for mean reversion in that underperforming asset class. The gap between small and large-cap stocks has not been this wide since 2000. We also favor investing in a barbell approach with one end focused on Energy, Financials, and Health Care. Conversely, we look for well-priced growth companies with liquidity, strong free cash flow, and a solid and defensible leadership role in their sector. We suggest rebalancing the portfolio quarterly to keep the barbell level.

B. Riley Wealth Management
Chief Market Strategist
Arthur Hogan
212-417-8041
ahogan@brileywealth.com