ECONOMIC OUTLOOK

DECEMBER 2024

Overview

Despite a forecast to the contrary by many experts, the U.S. economy demonstrated a deep resiliency in 2023 with robust employment and continued economic growth. While some industries were negatively affected by higher interest rates, the U.S. economy continued to see strong consumer demand and solid corporate earnings. However, in 2024 as higher interest rates continue to bite consumers and corporations alike, the economy may show some weakness and be set up for pattern of mixed results as well as moderate stock performance.

Fundamentals

The rate of inflation, which was the major story of 2022, has come off its highs and is reported at 3.14% as of November 2023. While this certainly is a vast improvement over the peak rate of 9.1% from June 2022, it is still above the Federal Reserve target rate of 2%. Additionally, since inflation has a compounding effect, the real prices of this inflationary period are meaningfully higher than pre-pandemic levels. These higher prices will put downward pressure on economic growth, at least in the near term.

The Federal Reserve has aggressively raised rates to counter the inflationary spikes adding another 1% of Federal Funds Rate hikes in 2023 on top of the 4.25% for calendar year 2022. Collectively, this marks one of the largest rate increases in history. Based on the most recent FOMC meeting, the forecast appears to have a more dovish stance where rate cuts may be more likely going forward although probably not until the second half of 2024.

The United States money supply has dramatically increased in recent years through excessive governmental programs and spending. According to the Federal Reserve Bank of St. Louis, the M2 money supply in the U.S. has increased 13.4% since 2020. Since peaking at nearly $9 trillion in April 2022, the Federal Reserve has reduced its balance sheet (of U.S. Treasuries) to $7.7 trillion. This quantitative tightening has served as an offset of increased governmental spending. However, higher interest costs for U.S. debt may require future expansion of the money supply and risk deterioration of the U.S. dollar.

The U.S. economy is projected to be 3.1% for 2023 according to the Congressional Budget Office. For 2024, the Federal Reserve predicts the U.S. economy will grow by 1.5% in 2024. This forecast is well below historical averages (2010-2019 average was 3.70 percent).

As of November 2023, the unemployment rate was 3.7% which was unchanged since November 2022. Additionally, the labor participation rate has increased to 62.6% from the April 2020 low of 60.2%. This represents additional job absorption although still .7% below its February 2020 level. These figures are clearly strong and have played, perhaps, the most important role in providing fuel to grow the economy broadly.

Corporate profits continue to be relatively strong in Q3. However, beginning with the quarterly reporting for Q4 beginning in January, company forecasts may not be all that rosy for 2024. Headwinds from interest costs, increased costs for materials and labor combined with softening demand, could lead to a moderate impact to corporate profitability. In this case, there could be higher than average cost cutting measures such as layoffs. A number of companies have already announced layoffs in 2023.

Key Developments

In 2023 there were several key developments that will have effects on future market conditions.

1) **Interest Rates Rise** – Interest rates were a major theme for 2023, with increases not just with the Fed rates, but all the other debt instruments including mortgage rates, auto loan rates, etc. Costs of borrowing will play a major role again in 2024 and drive deceleration in the economy especially in particularly prone areas such as real estate.

2) **Election Year** – The presidential election is in 2024 which will usher in more divisive politics and potentially more market volatility. The 2022 elections provided a split legislative branch of government, albeit a slim majority in both the Senate and House. This has limited any dramatic legislative changes that could affect the market. Depending upon how this likely hotly contested election season transpires, market conditions could be affected especially with added volatility as election day nears.

3) **Geo-Political Unrest** – Not much has changed since last year's review. The Russia-Ukraine war continues to add instability in Europe. Israel and Hamas conflict in the Gaza Strip has added another flash point of violence which has added instability both in the middle east and interestingly within the U.S. The United States' relationship with China continues to come under pressure. While China remains the largest trading partner, there are efforts both legislatively and corporately to diversify supply chains away from

the Chinese. These potential changes could have short and long-term impacts on corporations going forward.

Technical

As of December 15, 2023 the S&P 500 index and Nasdaq 100 index have had a sharply positive year, up 22.9 percent and 51.9 percent respectively for the year. From the technical perspective, the indices have clearly broken strongly to the upside. The latest strong upward movement in the SPX appears poised to reach new highs in the near term above the 4,818 level.

After having experiencing a meteoric increase from 4,100 (10/27) to 4,720 (12/15), there is a high likelihood of mean reversion. Watch for the index to retrace back to the 4,600 level or lower early in 2024.

From the technical perspective, the long-term pattern clearly indicates a bullish direction. However, it is noted that the slope of the upward trend is steeper than normal bullish movements. This should moderate to a more sustainable upward trend over 2024 through sideways or downward movements. It is likely a technical correction is on the way, although the bull trend is likely to continue limiting the impact of any downward movements.

Figure 1 - The S&P 500 (SPX) 15 Year - Weekly Chart

Figure 2 – S&P500 (SPX) 1 Year – Daily Chart

Jan '22 Mar '22 May '22 Jul '22 Sep '22 Nov '22

Expectations for 2024

The Federal Reserve appears likely to begin an easing cycle in the second half of 2024. This will have a positive effect on the economic outlook as interest expenses decrease. This will help with lower debt service costs for corporations, real estate owners and governments. However, this reduction of interest costs will likely be reflected in earnings in 2025 and later.

Corporate earnings will be under pressure for 2024 for a variety of reasons including higher labor costs, interest expense and potentially demand decreases. The labor market is tight and quality workers remain in great demand. This will likely limit the number of layoffs that would typically occur in a stagnating economy as companies recognize the difficulty in hiring quality workers. This will continue to serve as support for the general economy but potentially reduce profit margins with labor higher expense.

Demand decreases are likely to occur in 2024. Our expectation is that this demand softening will be wide spread although certain areas will be affected more than others, such as luxury goods or other non-essentials. Interest rate sensitive products, such as commercial and residential real estate or automobiles will be affected disproportionally. With respect to automobiles and other large ticket consumer products, corporate incentives are likely to return.

Geo-political risks continue to be elevated with both the Russia and China. It appears that the Russia-Ukraine war is no closer to any peaceful resolution although a full-scale NATO escalation looks less likely. In China there may be deteriorating economic conditions as the effects of demand decreases and supply chain changes take effect. The Israeli-Hamas conflict, aside from internal, civil disagreement, is unlikely to have any meaningful change to the U.S. and world economy.

Conclusions

In our view the economy with stagnate over the course of 2024. The economy appears to be moving slowly with a 1.9% growth rate forecast. Higher interest rates are slowly but surely impacting companies, governments, and consumers alike. Over time, these rates have a direct impact on capital decisions; investment, capital improvements, big ticket purchases. Corporate earnings will be under pressure, especially for leveraged institutions, and will require cost cutting to maintain.

Federal Reserve rate cuts appear to be on the way. This will undoubtedly be a positive and over time neutralize the interest rate impact present today. However, this will take time to ripple through the economy and unlikely to do much to impact corporate earnings in 2024.

Even with the fundamental economic pressures providing a negative outlook for 2024 corporate earnings, the indications for the stock market appear to be rosy. From the technical perspective, the markets are clearly in bull territory with an expectation of setting new all-time highs in the near future. In 2023, the market was buoyed by the tech giants while others languished. 2024 will be a continuation of the same, although the names may shift and perhaps the laggards of 2024 will be the leaders.

Looming on the horizon is the U.S. presidential election. There are many theories regarding the performance which is on average up 7%. However, it is difficult to speculate how this may affect markets. Given the divisive nature of politics we have seen recently, we expect this campaign season will be even more intense.

Other factors worthy of consideration;

Sovereign Defaults. The military conflict between Ukraine and Russia has led to sovereign defaults of both countries, together with Belarus. Other countries such as Ghana, Sri Lanka have also been severely strained with imbalances leading to defaults. While these are known issues, there is always a risk of an unknown fiscal imbalance that can have a domino effect across global financial systems, similar to the European debt crisis in 2008 which began in Iceland and spread to Portugal, Italy, Ireland, Greece and Spain. One such country to watch is China where 34 of 50 of the top real estate developers have defaulted on their debt. It is

unclear what impact this largely internal default would have on international relations, but should be noted as a possible risk of contagion across other China's interests.

Artificial Intelligence. In our view Artificial Intelligence (AI) has the potential to have more impact to our world than anything previously seen. Envision a world where you do not have to search Google for an answer, but merely ask a question of ChatGPT or Grok. This may be the least of AI's capabilities. Extrapolate machine learning to robotics (Tesla's Optimus) and we have the potential for dramatic changes beyond our current imagination. Like the tech boom of the 90s there will be winners and losers here, but the winners for AI will be huge and that boom may have already started.

De-dollarization. The U.S. Dollar has been the reserve currency for the world since 1944. However, in recent years world powers have worked to find alternatives to limit the power of the United States. One example includes China and Saudi Arabia who established limited trade relations with alternative currencies such as the Yuan instead of the Dollar or Euros. If this trend continues, the U.S. economic dominance will be undermined. This is a long-term concern, but is a major long-term risk to the stability of the U.S. The U.S. dollar valuation should be protected by the U.S. Government by limiting its devaluation through money supply expansion and exorbitant fiscal spending.

Crypto-Currency. Crypto-Currency continues its rise, albeit slowly. It has developed as time has progressed with U.S. regulators allowing various investment vehicles in recent years. This positive development will continue to expand the adoption although the industry has had significant setbacks with the failures of major crypto-exchanges such as FTX. However, at present the crypto market was valued at around $4.67 billion in 2022 according to Grand View Research. This is expected by some to grow annually at 12.5%. In our view, it is difficult to see the value as it exists today and until more use cases are widely available, it is doubtful that the alternative currency would be meaningfully adopted. Notwithstanding our conclusion, there still may be opportunity for growth in this space if the adoption trajectory continues and the use proposition expands.

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