MJM INVESTMENT ADVISORS, INC.

2024 Investment Outlook

Curb Your Enthusiasm

“The recession that was always 6 months away is looking more and more like the recession that never was. At the same time, disinflation and labor markets have stayed the course in a "Goldilocks" zone, allowing the Fed Chair Powell to signal cuts in 2024. ”

– Venu Krishna - U.S. Equity Strategist – Barclays Capital

“As we approach the end of the year, it is natural to look back on the progress that has been made toward our dual mandate objectives. Inflation has eased from its highs, and this has come without a significant increase in unemployment. That is very good news. But inflation is still too high, ongoing progress in bringing it down is not assured, and the path forward is uncertain. Given how far we have come, along with the uncertainties and risks that we face, the Committee is proceeding carefully.”

– Jerome Powell - U.S. Federal Reserve Chairman

“Enthusiasm is common. Endurance is rare.”

– Angela Duckworth - Psychologist

Meh!

Larry David – Curb Your Enthusiasm

Curb Your Enthusiasm started in 2000 on HBO (now called Max) and will debut its 12th and final season 😭 starting February 4, 2024. Larry David is the lead character in the show. Along with Jerry Seinfeld, Larry was the co-creator of Seinfeld, the brilliant TV comedy series about nothing, which ran from 1989 to 1998. The Seinfeld character George Constanza was based off of the real life Larry David, and some of the situations George found himself in on Seinfeld came from Larry David’s experiences in real life. On Curb Your Enthusiasm, Larry plays himself and the show is the politically incorrect version of Seinfeld. The show is based in Los Angeles and the cast includes both famous actors playing themselves in bit parts and actors with regular roles portraying show characters. The show’s scenes are mostly unscripted, which makes for a memorable TV comedy that can’t be replicated. Curb Your Enthusiasm can only exist on subscription TV as the topics Larry David weaves into the storylines would never make it through the censors on free TV.

George Castanza on Seinfeld and Larry David on Curb Your Enthusiasm both have a glass half empty view of life and the other human beings they come in contact with. The popular term meh, which means a lack of enthusiasm or interest in something, was popularized by Larry on Curb Your Enthusiasm. Larry’s socially unconventional behavior, lack of social filter, and blunt honesty always put him in the most awkward and outrageous but hilarious social situations. Given his neurotic, obsessive, and outspoken personality, Larry frequently make comments to others that should never be said and exactly at the wrong time. As a result, Larry’s ongoing social conflicts are all of his own doing, even though he believes everyone else to be the problem.

Fans of Curb Your Enthusiasm are saddened it's the show's final season but eagerly await how Larry will go out in the final episode on April 7, 2024 and his meh! attitude perfectly aligns with how investors should think about the return prospects for financial markets in 2024.

Going into 2023, the majority of professional investors expected recession and had subdued return expectations for the year but the economy and financial market returns turned out substantially better. Even though 2024 may not end up as bad as Larry's involvement in Fatwah: The Musical, there are four key reasons to curb your enthusiasm about 2024:

1. The market has priced in a soft landing for 2024, which means slower economic growth but no recession. There is a high level of conviction by investors in this outcome.

2. An aggressive level of interest rate cuts has already been priced into stocks and bonds. As captured in the Fed Funds futures market, the market has priced in 1.50% of interest rate cuts during 2024 compared to the Fed's own median forecast of 0.75%. Not only is 1.50% an aggressive assumption, but the spread between market expectations and the Fed's forecast is unusually wide. Rising expectations for more interest rate cuts during 2024 was the major catalyst behind stocks surging higher during November and December and reversing all of the decline from August through October.

3. Exceptionally large gains in both stocks and bonds during the final two months of 2023 most likely pulled forward some of 2024's return potential. The broad U.S. stock market as measured by the Russell 3000 Index had a substantial +26.0% return in 2023, including an outsized 15% gain during the last two months. The bond market also rallied into year-end, gaining 8.5% during the final two months, and reversing the negative returns that occurred through October with the Bloomberg Aggregate Bond Index returning +5.3% for the year.

4. The consensus S&P 500 earnings growth estimate at the start of 2024 is +11%. Even if the U.S. economy has a soft landing, this level of earnings growth is a bullish expectation that is already priced into U.S. stocks. It will take an even higher earnings growth outcome to be a catalyst for another year of strong equity returns and lower earnings growth will be a market headwind.

2023 was a meh type of year through the end of October and then everything changed very quickly. Through October 31st, the broad U.S. stock market returned +9.4% while core bonds returned -2.8%. A typical 60% stock / 40% bond balanced portfolio had gained only 4%. Starting in late October, bond yields plunged, stocks ripped higher, and by year-end the average 60/40 balanced portfolio had posted a +13.9% return. The key catalyst for the rally was several inflation readings coming in softer than expected, which caused market expectations for long-term inflation to plunge from October into year-end. The following chart shows 5-year future inflation expectations, which changed dramatically over the last two months of 2023, falling from 2.55% to 2.16% and barely above the Fed's 2% inflation target.

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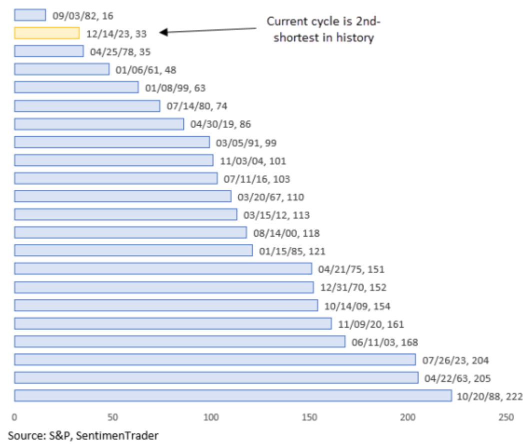
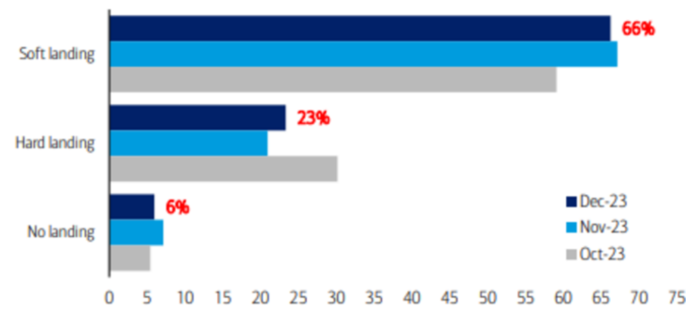
How fast was the stock market turnaround? As the next chart shows, it only took 33 days for the S&P 500 Equal Weighted Index to cycle from a year to date low to a year to date high.

This type of short market reversal is very rare. The next chart provides context for the November and December 2023 rally compared to other time periods when the U.S. stock market cycled the fastest from a 52-week low to a 52-week high. Over U.S. stock market history, there is only one other time when stocks made such a quick and dramatic reversal higher and that was coming out of the 1982 recession. Most stocks outside of the Magnificent 7 tech stocks struggled for most of 2023 until bond yields plunged starting in late October. The dramatic shift in forward interest rate expectations and plunging bond yields led many investors to rotate towards laggards that hadn't participated in the stock market gains for most of the year through the end of October and explains the sharp reversal higher in the S&P 500 Equal Weighted Index in the chart above.

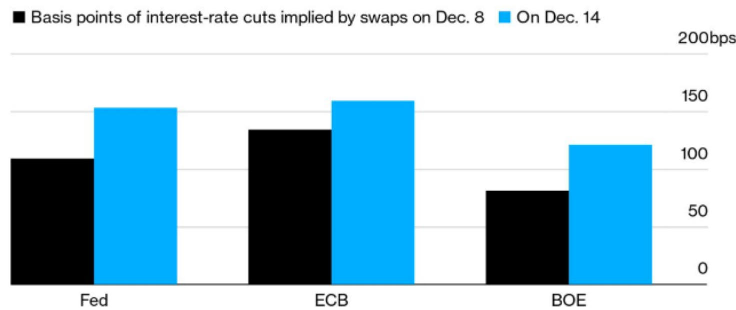


Even though participation in the stock market rally broadened out during the last two months, 2023 was still one of the narrowest return years on record, with 71% stocks trailing the S&P 500 Index return for the year. As shown in the next chart, this level far exceeds any year going back to 2000. Excluding the top 7 performing stocks of 2023, all of which were mega cap technology stocks, the remaining 493 stocks of the S&P 500 Index returned only 13% for the year compared to 26.3% for the total index.

U.S. economic growth exceeded expectations by a wide margin during 2023 and inflation levels receded as the year progressed. In terms of 2024 expectations, the next chart shows the December Fund Manager Survey conducted by BofA Global Research. There is a strong bias towards a soft landing for 2024, meaning slower economic growth but avoiding a recession. Over the past three months, expectations for a soft landing have increased to 66% of survey respondents while expectations for a hard landing or recession outcome declined from 32% to 23%. The latest survey of economists by the Wall Street Journal indicates a 39% probability of a recession within the next year, down from 48% in October, but only 1% real GDP growth forecast for 2024 compared to 2.6% for 2023. Heading into 2024, the majority of institutional investors believe the Fed's aggressive interest rate hikes have succeeded in moving inflation back towards its 2% target while avoiding both a recession and a big hit to the labor market.

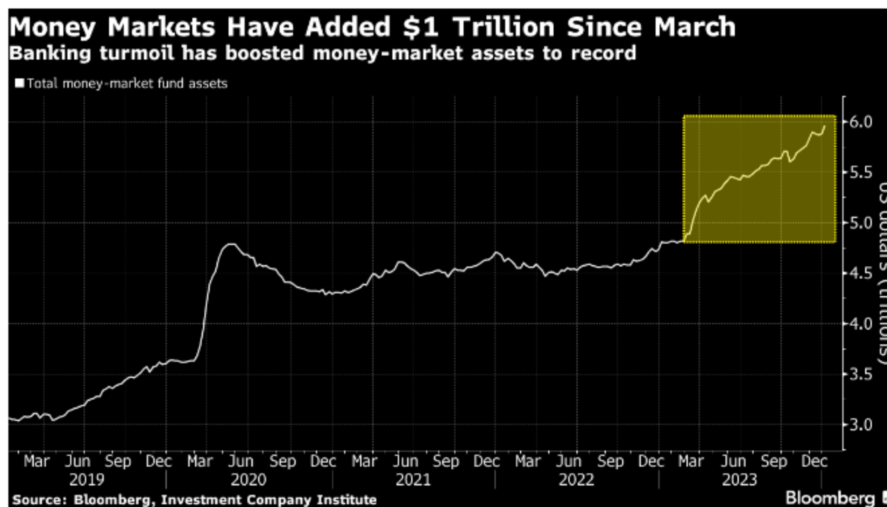


One of the bigger risks for 2024 is the spread between the market's expectations for Fed interest rate cuts vs. what the Fed itself forecasts through the end of 2024. The huge rally in both stocks and bonds late in 2023 was driven by the market participant's increasing conviction for an economic soft landing and more interest rate cuts during 2024. The chart below shows the level of interest rate cuts the market had priced in the week before the Fed's December meeting and afterwards. Market participants expected the Fed to cut interest rates 1.00% (100 basis points in the chart) during 2024 before the Fed's December meeting and afterwards that expectation increased to 1.50%. Interest rate cut expectations for both the European Central Bank and the Bank of England for 2024 also increased after their own respective December policy meetings. The consensus expectation is that three major central banks are done raising interest rates.



Every three months the Fed updates its Summary of Economic Projections and at its December meeting its median forecast of interest rate cuts increased from 0.50% to 0.75%. The Fed moved towards the market's 2024 interest rate cut expectations but the market further increased its 2024 interest rate cut expectations from 1.00% to 1.50%, which assumes the first 0.25% interest rate cut in March and 0.75% of cumulative interest rate cuts by June 2024. The first test of market expectations versus reality will likely come at the Fed's March 20th meeting. If inflation cooperates by further softening and the job market weakens, then the Fed will have more flexibility to cut interest rates at its March meeting. However, as Chairman Powell said at his December press conference, the path forward remains uncertain and that is no sure thing. If the Fed does not cut interest rates as much or as soon as the market expects then there is likely to be some degree of repricing of financial markets or a correction lower to adjust for a less bullish interest rate outcome. Stronger than expected economic data or a stronger than expected labor market would likely cause the Fed to push out interest rate cuts to later in the year.

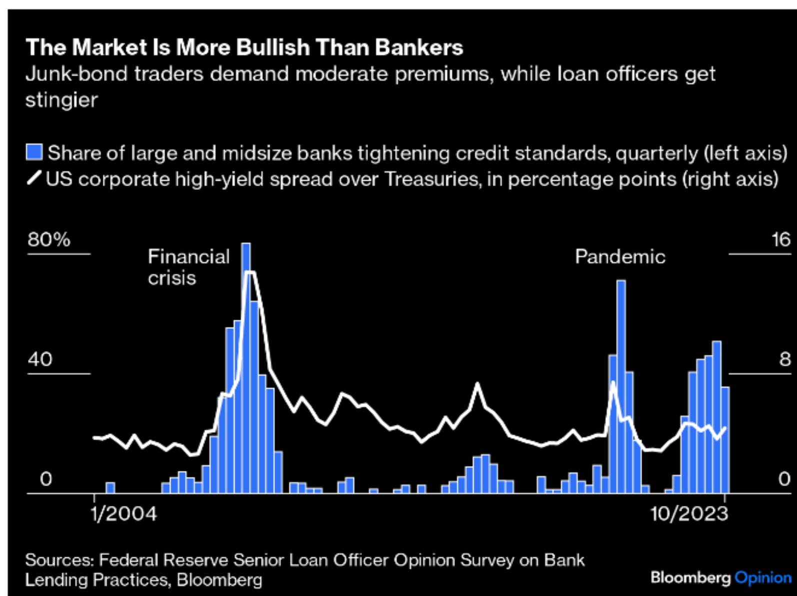
Another case the bulls make for 2024 returns is the amount of cash sitting on the sidelines available to be invested in other assets. As shown in the next chart, U.S. money market balances have risen dramatically to nearly $6 trillion. There was a notable surge starting in March 2023 when the banking crisis hit and that event propelled money market deposits higher for the rest of 2023. In addition, as the Fed increased interest rates to 5.25% by June 2023, a growing level of interest income accrued in money market balances. However, a large amount of the money markets increase since March 2023 came from transfers out of traditional bank saving accounts and was never destined for investment into stocks or bonds. Federated Hermes estimates that 80% of the increase in money market balances during 2023 came from transfers out of banks. When the Fed starts to cut interest rates, some of the cash in money markets may start to shift to other investments but how much comes out of money markets will depend on how fast and how much the Fed cuts interest rates. Most likely, it would take interest rate cuts of over 1.00% before money markets have any meaningful withdrawals because if inflation moves below 3% then even a 4.25% money market yield offers a positive real yield to savers. Over history, once money market balances rose, it was pretty sticking money and it took some time before the balances began to decline again.



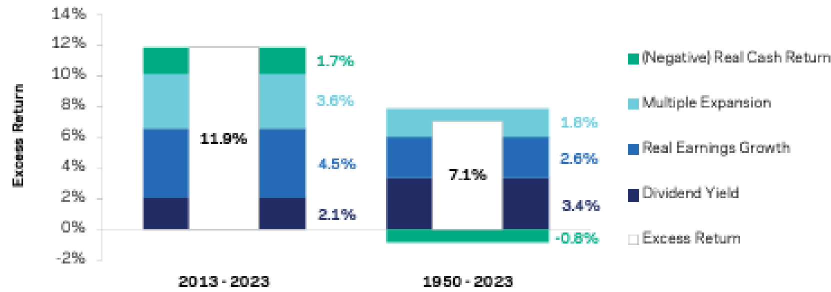
The large gain for the broad U.S. stock market during 2023 was primarily due to the massive outperformance of the Magnificent 7 mega cap tech stocks. Following a dreadful 2022, the Magnificent 7 surged 76% during 2023, receiving a major boost starting in June from investors chasing the Artificial Intelligence hype. That level of return recovery prices in a sizable degree of optimism and the U.S. stock market needs other stocks to pick up the baton in order to produce continued strong returns during 2024. If the Fed does end up cutting interest rates during 2024, and barring much weaker economic growth or a recession, small cap stocks would most likely be the biggest beneficiaries. Surging bond yields and investors enthralled with the Magnificent 7 created a major headwind for small cap stocks during the past two years. Any interest rate cuts during 2024 will reverse some of that headwind. In addition, valuation levels of small caps are at 30-year lows relative to large cap stocks. Even after a large 14% fourth quarter rally, small caps still trade at a 22% discount to their long-term valuation relationship with large cap stocks. The discount is even bigger in micro caps stocks, or stocks under $1 billion of market capitalization.

Credit risk could be a more challenging spot for financial markets during 2024 and most specifically for below investment grade bonds, aka high yield or junk bonds. As shown in the blue bars on the right side of the following chart, bankers became increasingly cautious and tightened lending standards during 2023. Historically, tighter bank lending standards have coincided with widening credit spreads for high yield/junk bonds but that didn’t happen during 2023. As shown by the white line in the chart, the last two major

financial crises caused by the 2020 Covid-19 pandemic and the 2008 Global Financial Crisis both caused widening credit spreads. Despite concerns at the outset of 2023 over recession risks and banks tightening their lending standards throughout the year, junk bond credit spreads remained under control because a recession never materialized. In addition, when interest rates were low, companies did a good job of extending their debt maturities and taking advantage of lower interest rates. If the Fed were to cut interest rates during 2024 and manage the economy to a soft landing outcome, then high yield bonds should offer attractive total returns given that yields are near 7.5% today. However, should the economy experience a bigger slowdown or a recession, then high yield bonds are at risk of bigger declines and especially since high yield credit spreads remain near historically low levels. It is worth noting that high yield bond returns have a high correlation with stock returns. High yield bonds gained 13.4% in 2023 when the stock market gained 26% but high yield bonds declined 12.2% when stocks declined nearly 20% in 2022.

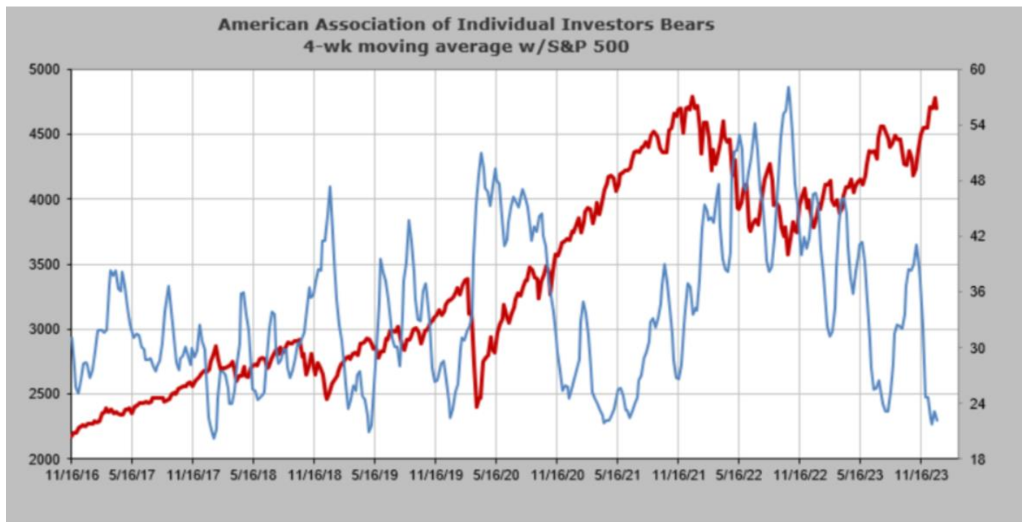


Despite the C-19 pandemic hitting the world economy hard in 2020, the past decade (2014 – 2023) of equity returns were quite robust and well above the long-term average. The next chart from AQR compares the past decade of annualized U.S. stock returns to the annualized return profile since 1950. The right bar chart shows the 73-year annualized return profile of U.S. stocks was 7.1% compared to an 11.9% annualized return for the past 10 years ending 6/30/23. Annualized stock returns for the past decade ending 6/30/23 were 4.8% higher than the 73-year long-term average. There are some legitimate reasons for this including more profitable companies and stronger earnings growth in recent decades. However, another major benefit was unusually low interest rates over the past decade, which had a very positive effect on asset values. Over history, low interest rates and bond yields have led to higher valuations for other asset classes like stocks, real estate, and private equity. The last 10 years of U.S. stock returns have been buoyed by annual returns exceeding 20% in 2023, 2021, 2020, and 2019. For the trailing 5-years ending 12/31/23, the broad U.S. stock market as measured by the Russell 3000 Index returned 15.1% annualized or more than twice the long-term annualized return profile for U.S. stocks. In addition, over the past decade, multiple expansion (higher price earnings ratio) has contributed twice as much to returns as it has historically and is explained in part by the lower interest rate environment that existed from 2009 until 2022 and before the Fed began to aggressively increase interest rates.

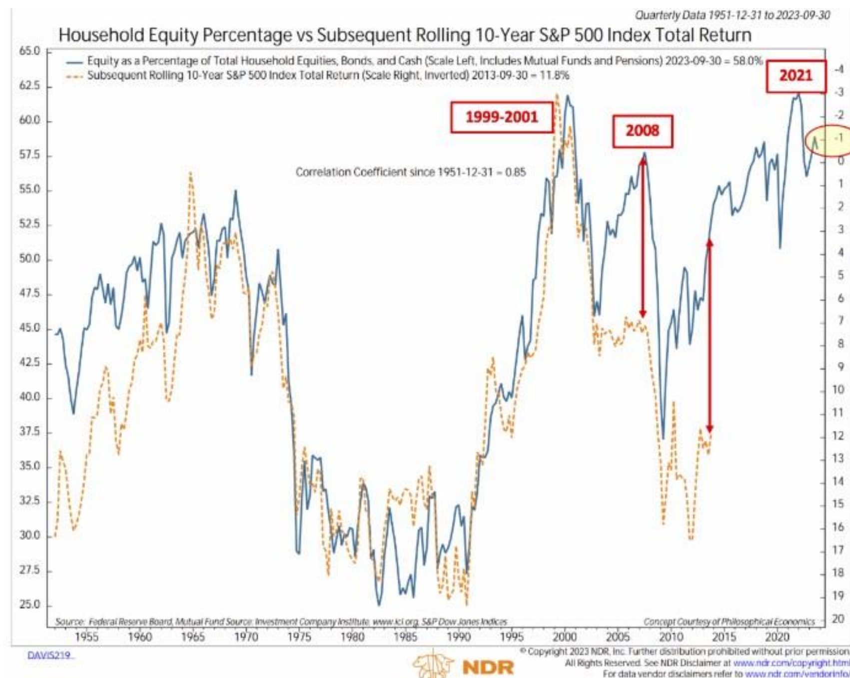


With U.S. stock market returns in recent years significantly above the long-term average and the valuation profile of U.S. stocks being the highest in the world, the return setup for U.S. stocks in the years ahead will be more dependent upon earnings and dividend growth instead of PE multiple expansion.

As financial markets put on a strong year-end rally over the last two months of 2023, investor sentiment, which was at low levels at the end of October, reversed higher and became quite ebullient by year-end. The glass half-empty, Larry David type of investors capitulated, as captured by the blue line in the next chart showing the percentage of individual investors who consider themselves bearish. There weren't many bears left in the meh! camp of investors. Sentiment works in a contrarian fashion, especially with retail investors, who are always overly bullish at the top and overly bearish at market bottoms. The last time the number of bearish investors was this low was in the middle of 2021 when U.S stocks finished the year with a +25.6% return. In 2023, bearish sentiment peaked in late October, right before stocks ripped 15% higher and finished the year up 26.3%. If Larry David were describing 2023, he would say it was prett-ay, prett-ay, prett-ay good. Right now, with bullish sentiment elevated, a majority of investors believe that 2024 will also be prett-ay, prett-ay, prett-ay good.



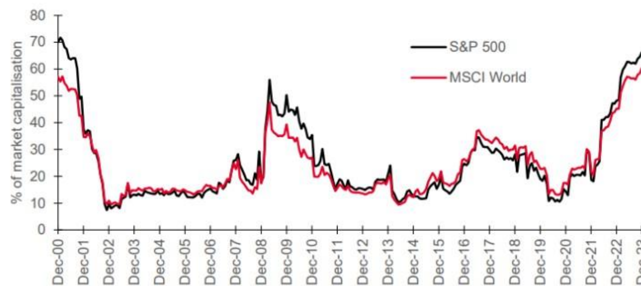
Ned Davis Research has a very interesting chart that captures the historical experience of investor bullishness and how that has translated into future returns. The message captured in this next chart is when investor allocations to stocks are high, future returns are low, and vice versa. This is similar to investor sentiment being a contrary indicator. The blue line (left hand scale) in the next chart is the household equity allocation percentage going back to the 1950s. Historically, when households, aka individual investors, have their highest weighting towards stocks, the subsequent 10 years of actual stock performance is among the lowest as represented by the dashed yellow line (right hand scale, inverted). For example, the biggest peak ever in households owning equities was the 1998/1999 Tech Bubble when the typical household had just over 60% allocated to stocks. The dashed yellow line shows that in the following 10 years (2000-2009), the 10-year annualized return for stocks bottomed at -3% annualized.



The end of 2021 was the next time households held as high an allocation to equities as they did at the peak of the Tech bubble. Over the next decade (2022 to 2031), and if this historical relationship stays as tightly correlated as it has in the past, stock returns are likely to be much lower than the +11.5% annualized return of the past 10 years. Over the next 10 years, the dashed yellow line should move higher (meaning annualized returns are going lower) and converge towards the blue line, just as it has done over the past 70 years of stock market history. Using the Russell 3000 Index, the first two years of this next decade started with the 2022 return of -19.2% and a very strong 2023 return of +26.3%, which calculates to a two-year annualized return is just +1.0%. So, 2023 certainly felt prett-ay, pretty-ay good, but the last two years are proving out the tight correlation between high equity allocations and lower future returns in the chart above. It’s a strong message to curb your enthusiasm for what U.S. stocks might deliver in the years ahead.

Another important factor that will impact stock market returns in 2024 is what happens in the bond market. The following chart shows the rolling 5-year correlation between stocks and bonds going back to 2000 or 23 years. Currently, the correlation is quite elevated, meaning stock returns are highly sensitive to changes in bond yields. This market dynamic means that what happens in the bond market and to bond yields is an extremely important factor on stock market performance. In this case, lower bond yields means higher

stock returns and vice versa. Remember during 2022 when bond yields surged higher and the Fed was aggressively increasing interest rates to get elevated inflation under control? The stock market tanked nearly 20% for the year. In 2023, stocks were doing so-so through October until bond yields plunged towards the end of the year, leading to a 15% gain in stocks during November and December and +26% return for the year. At the start of 2024, market participants are assuming that bond yields have peaked and the Fed will cut interest rates by 1.50% during 2024 and so lower interest rates are already priced into the stock market. If bond yields move higher, that outcome will be negative for stock returns.



As challenging as the forward return outlook could be for stocks in 2024 and beyond, bond return prospects have improved substantially as bond yields surged higher during 2022 and 2023. At the end of 2023, core bond portfolios offered yields of around 4.75% and some parts of the bond market including high yield bonds and emerging market debt offered yields in the 7%-8% range. This yield profile is dramatically different than the early part of 2022 and before the Fed raised interest rates by 5.25%. At that time, a core bond portfolio offered a 1.9% yield profile. For balanced portfolio investors, bonds have once again become an important source of return and risk diversification. In addition, with inflation moving lower and CPI finishing the year around 3%, bonds offer the highest real yield (bond yield – inflation rate) profile in over a decade.

Summary

Larry David would say 2023 turned out prett-ay prett-ay pretty good and was far better than investor expectations coming into the year. Given outsized stock and bond gains during the last two months of 2023, there is a strong bullish bias entering 2024. However, 2024 could turn out to be like how most episodes Curb Your Enthusiasm end up, with Larry in a far less satisfying situation than he could have imagined. Unlike every hilarious episode of Curb Your Enthusiasm, markets are never funny. Rather, they usually end up either satisfying or disappointing and the actual outcome is usually much different from the expectations at the beginning of the year. In early January, retail and institutional sentiment indicators were all comfortably in the Greed category, the majority of market participants expected a soft landing for the economy and for the Fed to cut interest rates by 1.5%. The market tone at the start of 2024 is optimistic and like the excitement Larry's guests felt on the opening night of his new restaurant. Let's hope 2024 doesn't turn out as disastrous, with the head chef with Tourette's shouting expletives through the open window of the kitchen and guests hurling expletives at each other.

Mark J. Majka, CFA
Chief Investment Officer
January 17, 2024

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