NORTHEAST SEQUOIA
PRIVATE CLIENT GROUP

2024 Outlook

Avoid Making Wrong Mistakes

Christopher Pike, CFA®
chris.pike@northeastprivate.com
973-422-9140

Mark Murphy, CLU®, ChFC®
Adam Schlosberg, CFP ®
Benjamin Bush, CLU®, ChFC®
James V. Ulrich, CRPC®
Christopher Viola, AIF®

Contents

Executive Summary 2
2023 Year In Review 3
Tale Of The Tape 4
2023: Not Your Typical Recovery Year 5
The Fab 7 8
Sector And Style Recap 10
2024 Outlook 12
The Year Of Living Dangerously 12
Whistling Past The Grave Yard 12
Geopolitical Backdrop 14
Election Year Dynamics 16
Economic Headwinds 19
Capital Market Outlook 28
Hope Is Not A Strategy 28
Still Expecting A Slowdown (aka Recession) 28
Inflation, Interest Rates, And Recession Expectations 30
Needing More Than Just Immaculate Disinflation 30
Our Recession Obsession 36
2023 Positioning 42
Bullish On Yields & Defensive Growth 42
Base Case: Milder Recession = Milder Recovery… 44
Disclosures: 47

Executive Summary

- When drafting our 2023 Outlook, we could not have anticipated how accurately our forward thesis captured the reaction function between the equity markets and economy – at least through the first ten months of 2023. The combination of the "Fab 7" and a late-year surprise dovish tilt by the Federal Reserve helped the S&P 500 sail past our 2024 target of 4,200, ending the year at 4,770, providing investors with a 26.3% total return.

- Technology was the top-performing sector in 2023 (higher by 55%). Growth names were up by almost 43%, extending a 5-year run of almost 20%/year, and Cyclicals increased by nearly 40%, driven by Discretionary names. Defensives were virtually flat on the year, driven by negative returns in Utilities and Staples and low-single-digit positive returns in Healthcare.

- On the surface, the 2023 economy was resilient. However, from our perspective, we remain stunned by the complacency permeating capital markets - as if many investors and pundits have been anesthetized by the mounting domestic/global economic, geopolitical, and capital market headwinds forming. As usual, Wall Street focuses on the optimistically probable versus realistically skeptical.

- Investors should never entirely discount black swan events, especially in a year of a U.S. Presidential Election and during a period when our country has never been so divided. A year ago, we found ourselves similarly perplexed regarding investors' complacency. However, there were far fewer hazards to contend with at the time. Today's risks include a potential U.S. recession, the ongoing war between Russia and Ukraine, Israel's war with Hamas, escalating conflicts with Iran proxies, a pro-democratic victory in Taiwan, a splintered relationship with China, and the ever-growing nuclear aspirations of North Korea and Iran.

- After finally recognizing an inflation threat not seen since the '70s, an aggressive response by the FOMC may have caused financial conditions to become overly restrictive. And while "better late than never," we now believe a misguided "dovish pivot" by the FOMC in late 2023 may have positioned investors as being too optimistic regarding 2024 rate-cut expectations.

- Based on our research and analysis, we believe the U.S. may have already entered a recession, a prognostication we do not take lightly. But we remind our readers that dating as far back as our 2022 Outlook, we had stated the next recession would be shallow and short. Equally as contentious, we believe if the COVID-19 pandemic had been averted altogether, we doubt the U.S. would have fallen into the 2020 recession and thus end the longest U.S. expansion (128 months) in the history books.

- Our research comparing the relationship between expansions, recessions, and resulting capital market and economic outcomes suggests equity market returns in 2024 will be muted. We believe investors have already "pulled forward" some of 2024 returns during November and December 2023. Further, we found that the S&P typically returns roughly 7-8% during election years. From a quantitative perspective, we estimate a fair value for the S&P (price-only) of between 4,900 and 5,000 (a 6-7% total return) during 2024. Assumptions driving this forecast are: 1) forward 12-month S&P earnings **averaging** about $265-270 per share during the year, 2) a 10-year Treasury Yield of 3.25% **by year-end 2024**, 3) an S&P Earnings Yield Assumption of 5.75%, equating into a pre-recession multiple of roughly 17.5x, and 4) a post-recession multiple premium assumption of roughly 19.5x. **However, two caveats underpin this forecast: the timing of any potential recession during 2024, and the potential fallout of the 2024 election cycle.**

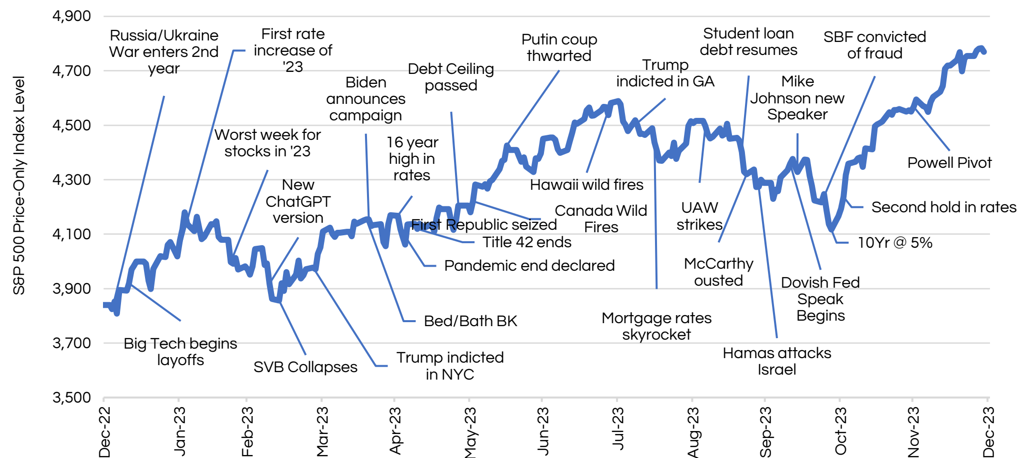
- We believe that investors may have assumed too many rate cuts in 2024. The FOMC needs optionality, and we fear a misguided and premature dovish tilt may pose near-term resistance for bonds. And while we believe rate cuts will occur sometime in 2024, we expect the delay of any **significant** cuts until later into the second half of the year unless more dire circumstances warrant. Further, we think any potential recession will not cause an increase in corporate defaults or any material widening of bond spreads. While a fair amount of yield compression has already occurred, we recommend that investors use sell-offs (higher yields, lower prices) to extend duration in bonds (and preferred equities) with solid credit ratings. Finally, we feel that High-Yield Corporate bonds potentially offer attractive total returns, assuming the next recession is mild.

2023 Year In Review

Tale Of The Tape

The combination of the "Fab 7[1]" and a late-year surprise dovish tilt by the Federal Reserve helped propel 2023 market returns ahead of our expectations. However, we were not the only ones surprised[2], as several sell-side economists and strategists[3,4] continued to walk up year-end targets through most of 2023.

Exhibit 1: 2022 Tale Of The Tape



NEPCG and FactSet data as of 12/29/2023

The S&P 500 returned 26.3% in 2023 (including dividends). This capital market outperformance occurred despite our view that investors continue to whistle past the graveyard from geopolitical, fiscal, and monetary perspectives.

2023 began with the Russia/Ukraine war entering its second year. This was shortly followed by the first Fed Funds rate increase in 2023 (to 4.75%, upper bound) and the eighth in a series of 11 rate increases, combining to be the most aggressive interest rate cycle since the 1970s. Early 2023 exhibited what some economists may consider "rolling recessions" across several industries, including housing, Healthcare, and, more notably, the Technology Sector. The equity market fell in sympathy as the Federal Reserve continued to increase overnight borrowing rates throughout the year. By early Spring 2023, several regional banks were also put in the crosshairs of

[1] Apple, Microsoft, Google parent Alphabet, Amazon.com, Nvidia, Meta Platforms and Tesla.
[2] 2023 Wall Street Forecasts for The S&P 500: Huge Dispersion (12/4/2023).
[3] Goldman Sachs ups year-end S&P 500 price target to 4,500 (6/9/2023).
[4] Goldman sees S&P 500 rising to 4700 by year-end 2024 (11/15/2023).

interest rate increases, either due to their exposure to residential housing and commercial real estate or, as in the case of Silicon Valley Bank, a significant mismatch in their asset/liability exposure. As consumer savings rates increased in tandem with the highest inflation rate in almost two decades, retailers also felt the pain, spurring the long-anticipated bankruptcy of Bed Bath and Beyond.

From a geopolitical perspective, the U.S. witnessed the first indictment of a former President, a coup was thwarted in Russia, a contentious debt impasse was resolved and passed, and wildfires wreaked havoc across Canada and Hawaii. By mid-summer, former President Trump was once again indicted, this time in both Florida and Georgia. By the Fall of 2023, Representative Kevin McCarthy was removed as Speaker from the U.S. House of Representatives despite pushing through bi-partisan debt ceiling legislation six months earlier. Unfortunately, this vacancy coincided with the Hamas terror attacks and restricted the ability of the U.S. to pass any military aid to Israel. Soon after that, Mike Johnson was elected as Speaker despite the juvenile and selfish aspirations of certain Republican caucus members. At the same time, several Fed Governors slowly began to jawbone a more dovish message.

By October 2023, the 10-year Treasury Note breached 5%, a level last seen during the Great Financial Crisis of 2007. We believe this pressured investors to believe the FOMC needed to act soon to stave off further market turbulence. However, the FOMC held rates steady at 5.5% (upper bound) for a second straight meeting. Regardless, we believe investors remained steadfast in pricing in 2024 interest rate cuts associated with what is now coined the Powell Pivot, helping ignite a fierce bounce in equities and a recovery in the fixed-income market. The equity market continued to ascend through the remainder of 2023 by another 3%.

2023: Not Your Typical Recovery Year

In 2022, the S&P 500 was down 18% on a total return basis, which was the worst year for the S&P 500 index dating back to the Global Financial Crisis[5] (GFC) in 2008, when the S&P was down by roughly 37%. A year ago, in drafting our 2023 Outlook, we suggested equities

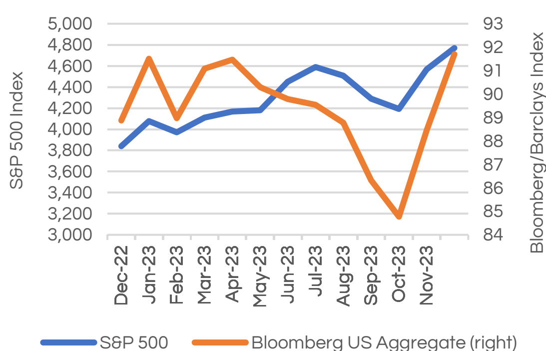
[5] The GFC refers to the period of extreme stress in global markets between mid-2007 and early 2009

should typically recover in the year following a significant sell-off, albeit with considerable volatility.

Although we cannot dispute the solid 2023 results, as we drill deeper, we find that seven companies coined the Fab 7 (representing about 25% of the S&P market capitalization throughout the year), accounted for as much as 65% of the S&P's 2023 total return. Further, most of the upside in fixed-income markets occurred between mid-October and late December, as the 10-year Treasury Note fell from over 5% to as low as 3.8%. In our opinion, this entire move was driven by market expectations that the FOMC would cut rates by as much as 130 basis points by July 2024, coinciding with the notion that the U.S. will avoid recession altogether. In the sections that follow, we attempt to unpack and support our more cautious expectations for 2024.

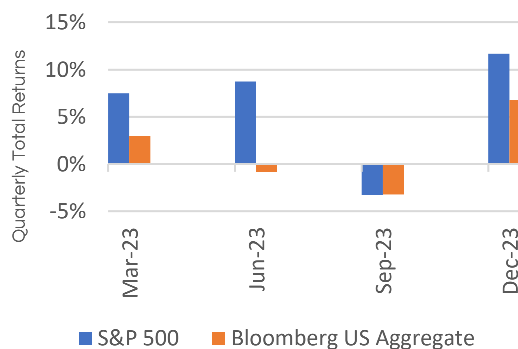
As we illustrate in Exhibit 3, by the end of 1Q23, the S&P 500 was higher by 7.0% on a price-only basis and higher by 7.5%, including dividends. These results were despite a 2.6% sell-off in February 2023 and an additional retracement to 2023's lows. However, through the remainder of March 2023, the S&P bounced by 3.5%. The Bloomberg/Barclay's U.S. Aggregate increased by 2.5% in price terms during 1Q23 and 3.0% on a total return basis. By June, the S&P was up an additional 8.7%, closing the first half of 2023 at 4,450.

Exhibit 2: 2023 Index Total Returns



FactSet and NEPCG

Exhibit 3: 2023 Quarterly Total Returns

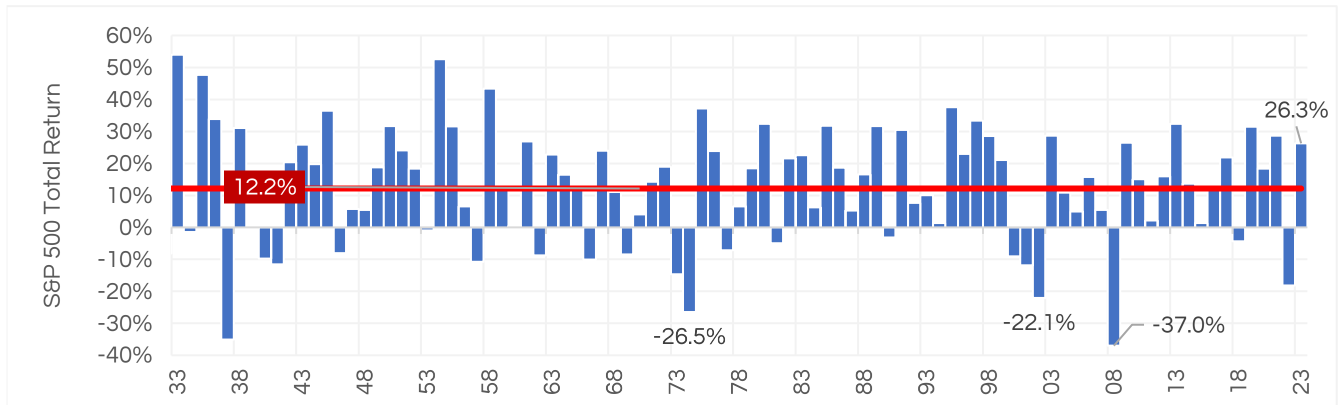


FactSet and NEPCG

At the start of the second half of 2023, fixed-income markets began to feel the full brunt of increasing interest rates, a downtrend that would last for most of the year. Equities moved in sympathy with bonds during the Summer of 2023, also bottoming in late October. In

addition, the Santa Clause Rally[6] came early for investors in 2023. During the months of November and December, the S&P gained by 8.9% and 4.4%, while the Bloomberg/Barclays Aggregate increased by 4.4% and 3.7%, respectively.

Exhibit 4: S&P 500 Annual Returns



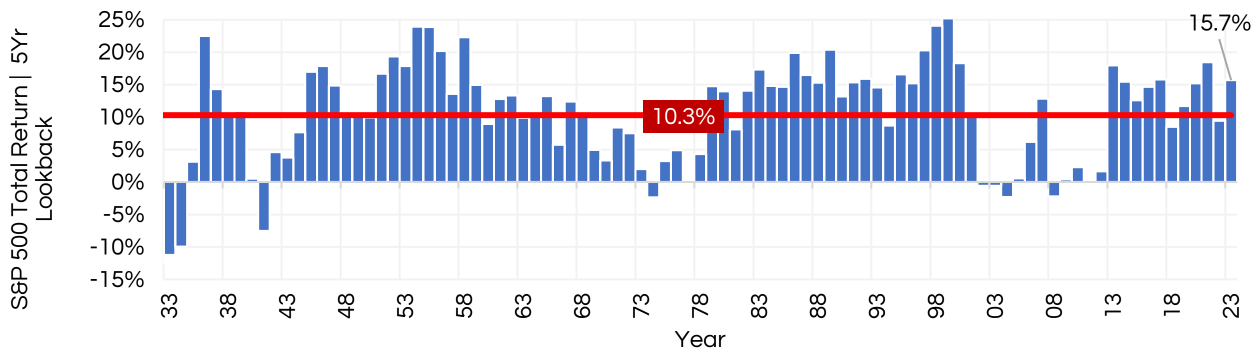
NEPCG and FactSet, data as of 12/29/2023

The robust returns in 2023 increased the S&P annualized total return to 12.2% annually. Exhibit 4 above illustrates the annual average total return of the S&P 500 dating back through the Great Depression. Incorporating 2023 results, we found that since 1926, there have been 72 years (73% of the time) in which the S&P has delivered a positive return with an average of 21.4%. At the same time, there have been 26 (27% of the time) years that the S&P returned negative results, averaging negative 13.4% per annum.

Further, the 26% upside in 2023 also supported the 5-year annual lookback total return for the S&P 500, restoring the time series return to roughly 10.3%. Exhibit 5 below illustrates the 5-year total return holding period for the S&P 500 during, through the Great Depression.

[6] The tendency for the stock market to rise on the last five days of the old year, and the first two days of the new year. However, this year, markets responded following more dovish messaging from the FOMC, rather than what has been coined a "Santa Clause Rally."

Exhibit 5: 5Yr Compound Annual Total Return Look Back



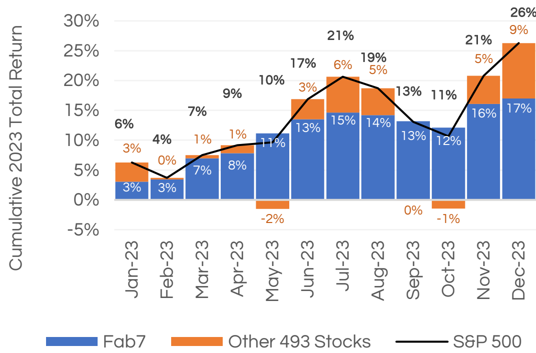
NEPCG and FactSet data as of 12/29/2023

Incorporating 2023 results, we found that when analyzing the historical 5-year annual total return dating back through 1926, there were 81 positive five-year periods/instances (87% of the time), whereby the annualized return averaged 12.6%. On the flip side, there were 12 periods/instances (13%) whereby the S&P was down on average by 4.6% per year. ***All of this data supports our view that equity investors who are patient and disciplined are typically rewarded through market cycles. In contrast, traders who respond to emotions generally are punished***.

The Fab 7

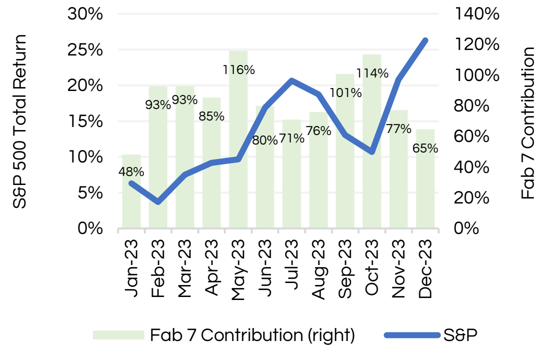
In this section, we further unpack our analysis regarding the Fab 7. In reviewing 2023 results, investors need to acknowledge the significant support provided by the Fab 7, the constituents of which include AAPL, MSFT, AMZN, NVDA, GOOG(L), META, and TSLA. These seven names represented almost 20% of the S&P market capitalization at the start of 2023 and were collectively higher by over 75% on a market capitalization-weighted basis throughout the year. As we illustrate in Exhibit 6 and Exhibit 7 below, the Fab 7 contributed 17% of the aggregate 26% S&P total return, representing as much as 65% of full-year results.

Exhibit 6: Aggregate Fab 7 Contribution



FactSet and NEPCG

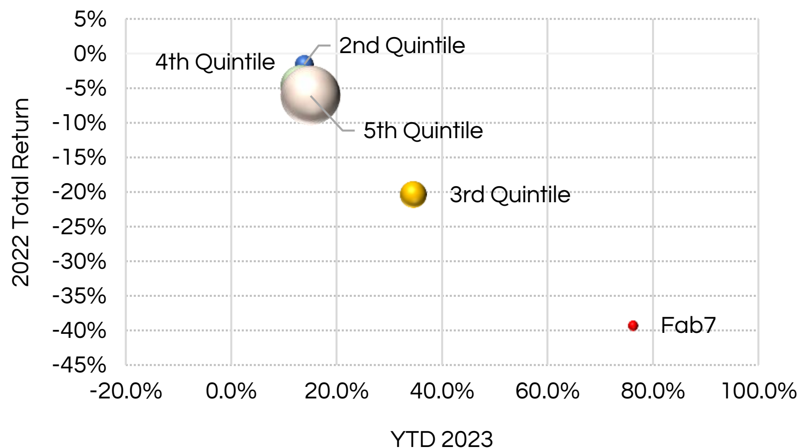
Exhibit 7: Fab 7 Contribution By Month



FactSet and NEPCG

Exhibit 8 compares the impact of the Fab 7 on returns in both 2022 and 2023. We present the market cap quintiles[7] such that the size of the dot plot illustrates the aggregate number of companies comprising each quintile. For example, the first quintile (top 20% of S&P companies by market capitalization at the start of '23) is comprised of only seven (7) companies, whereas the fifth (last) quintile (the last 20% of S&P market capitalization) is comprised of roughly 278 names/stocks.

Exhibit 8: 2023 Total Return By Market Cap Quintile



NEPCG and FactSet, data as of 12/29/2023

While the Fab7 names were higher by roughly 75% during 2023, collectively, these same names were down by almost 40% in 2022. Said differently, if an investor invested in only these seven names in 2022 and 2023, their total return would be roughly 5%, while the

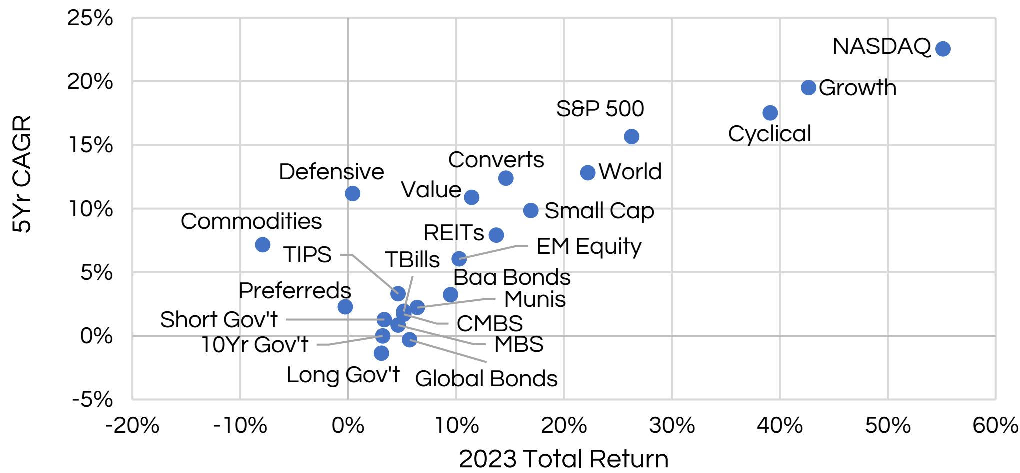
[7] A quintile is a statistical division of a set of data into five equal parts, representing 20% each.

S&P 500 would return only 3.4% during the same 2-year holding period.

Sector And Style Recap

2023 revealed significant divergence among various sectors and investment styles. Technology was the top performing sector in 2023, as evidenced by the NASDAQ 100 returning 55.1%, ending the year at 16,826, close to its all-time high of 16,907 posted on December 27, 2023. Following the Technology-laden NASDAQ 100, Growth names were higher by almost 43%, extending a 5-year run of nearly 20% per year. Cyclical names were higher by almost 40% in 2023. However, these results were skewed by the outperformance of Consumer Discretionary higher by 42%, while more traditional Cyclicals, including Financials and Industrials, were higher by 12.1% and 18.1%, respectively. Global equities rose 22.2% during 2023, while Emerging Market Equities rose 10.3%. On the downside, Commodities were down by almost 8% for the year, and Defensive names, overall, were virtually flat on the year, driven by negative returns for Utilities (-7%), Staples (flat), and low-single-digit returns for Healthcare (2%).

Exhibit 9: 2023 vs 5Yr CAGR | Capital Market Total Returns



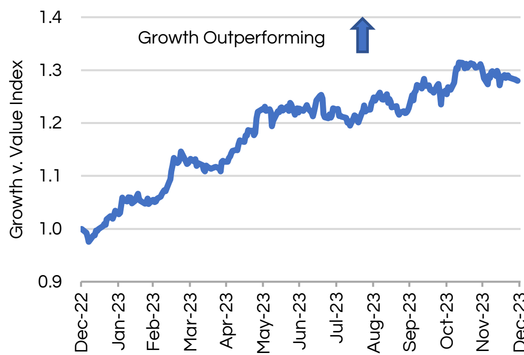
NEPCG and FactSet data as of 12/29/2023

The fixed-income sector, in aggregate, exhibited a significant degree of volatility during 2023. After enduring a rapid backup in interest rates through most of the year, bonds benefited from a 120bps drop in the 10-year Treasury Note yield to 3.8% between October 19, 2023, and December 27, 2023. The best-performing sector within the fixed-income complex was Convertible Bonds, which returned 14.6%, followed by Investment Grade Corporate Bonds (Baa) at 9.5%. The

worst-performing fixed-income sectors were Long Government Bonds and Preferred Equity Securities, producing total returns of 3.1% and negative 0.1%, respectively.

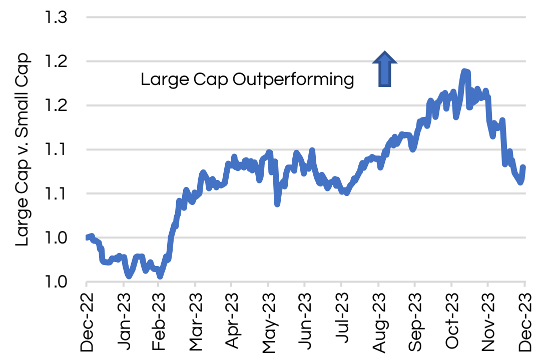
As previously noted, Growth significantly outperformed Value for most of 2023, except during the brief sell-offs in late spring and mid-summer and the last two months of the year.

Exhibit 10: Growth vs. Value



FactSet and NEPCG

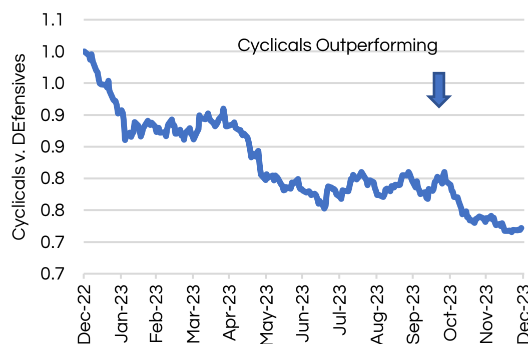
Exhibit 11: Large Cap vs. Small Cap



FactSet and NEPCG

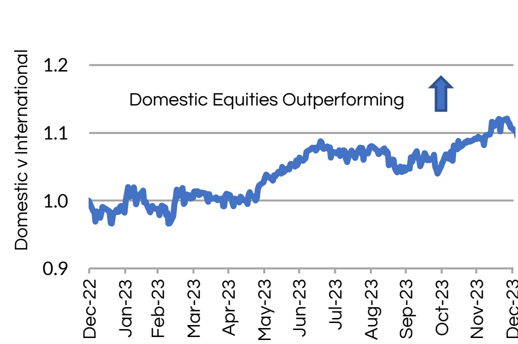
Similarly, Large-Cap names notably outperformed Small-Caps for most of 2023, as Large Cap Technology names overwhelmed the bullish narrative for the year. Cyclicals also outperformed Defensive names except during the same periods during which Value outperformed Growth.

Exhibit 12: Defensive vs. Cyclicals



FactSet and NEPCG

Exhibit 13: Domestic vs. Global



FactSet and NEPCG

Finally, Domestic Equities outperformed their International counterparts during 2023. However, from a regional and country perspective, returns were disparate. For example, the FTSE 100 (U.K.) was up only about 8% in 2023, while Germany (DAX) and France

(CAC) were each higher by about 20%, and Italy was higher by 32%. The Asia-Pacific region produced a total return of about 14%, driven higher by South Korea and India, with China and Australia lagging. While we anticipated the U.S. equity market would outperform non-U.S. stocks, the same theme holds – a handful of names drove most of the relative outperformance.

2024 Outlook

The Year Of Living Dangerously

Whistling Past The Grave Yard

We remain stunned as to the level of complacency exhibited by capital markets. It is as though many investors and pundits are anesthetized to the mounting domestic/global economic, geopolitical, and capital market headwinds we face. **We believe Wall Street focuses on the optimistically probable versus realistically skeptical.** The contrary is that we are the bears and too pragmatic regarding the domestic/global economy, the geopolitical challenges we face here and abroad, and the FOMC's ability to orchestrate a soft (no) landing. But let's unpack.

First, the unprecedented response on behalf of global central banks in slashing interest rates and injecting liquidity into the global banking and capital markets is still running its course. While we hoped for a more Monetarist[8] approach to normalization following the COVID-19 pandemic, we believe a Keynesian outcome, namely one with "long and variable lags," is the likely result. So, the pulling forward of as much as 100-150bps of rate cuts by July 2024, which helped propel asset values in the last two months of 2023, draws us concern and is now being questioned by the market. We believe the FOMC will most likely leave the Fed Funds rate at a higher level for a more extended period unless the U.S. economy sinks into a deep recession or if idiosyncratic risks emerge and escalate rapidly.

Secondly, while our prediction regarding immaculate disinflation[9] has partially come true, consumers do not purchase a "rate of change" in a product or service; they buy the good or service at the current price.

---

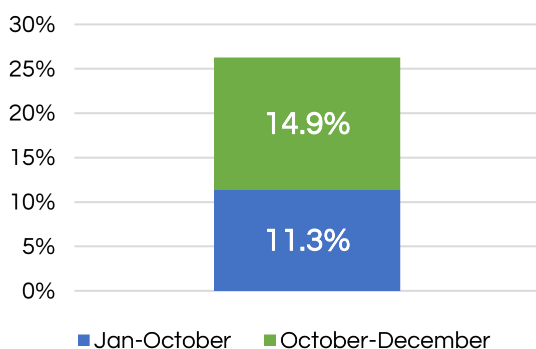
[8] Monetarism focuses on controlling the money supply to control the economy. Keynesianism focuses on government spending to control the economy. Monetarists believe in fighting inflation by adjusting the amount of money in circulation. Keynesians acknowledge some value in monetarism's effect on GDP but feel that monetary adjustments take too long to be felt. Both economic theories are used by lawmakers to create fiscal and monetary policies.

[9] While there's no official definition of immaculate disinflation, the phrase is being used to describe a scenario where inflation cools without causing a spike in unemployment.

In other words, higher costs are already entrenched in many aspects of our economy. Further, while specific segments of the economy are experiencing **disinflation** (a slowing of inflation), we have yet to see an aggregate **deflation** (a reduction in prices) trend. In addition, not only is global growth expected to soften in '24 on a sequential basis, but in almost all cases, prior consensus estimates for '24 and '25 global GDP growth prospects are being re-rated down.

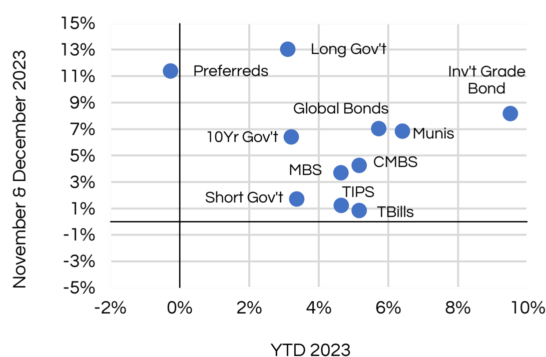
And as we have discussed earlier, much of the jubilation exhibited by investors as of late has been driven by the "better than good" 2023 returns, driven by the outsized returns of the Fab 7. We believe positive stock returns are akin to endorphins; the greater the return, the better business and individuals "feel" about their current situation.

Exhibit 14: Fab 7 Return Contribution



FactSet and NEPCG

Exhibit 15: 2023 Fixed Income Returns



FactSet and NEPCG

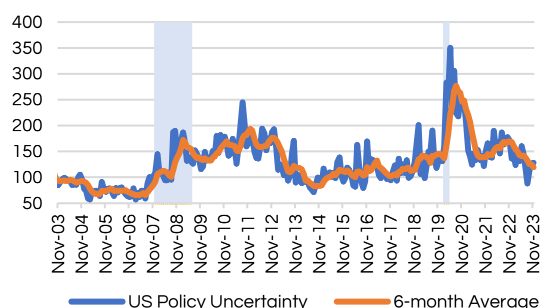
In addition, most of the upside in fixed-income markets during 2023 also occurred in the last two months of the year, for the same reasons above, as the yield on the 10 Year Treasury Note compressed from over 5% in mid-October to as low as 3.8% by late-December.

So, as we will unpack later in this report, we believe the next recession has already begun and will have similar characteristics to that of the 2001 recession, without the brutal economic and financial market aftermath of the 9/11 terrorist attacks that occurred in New York City, the Pentagon and Shanksville, Pennsylvania.

Geopolitical Backdrop

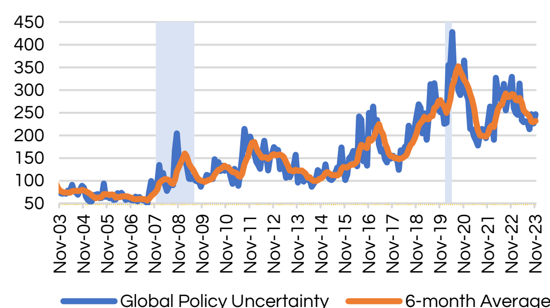
We reiterate that investors can never entirely discount black swans[10]. **This may be especially true in the year of a U.S. Presidential Election when it can be argued that our country has never been so divided.** A year ago, we found ourselves similarly perplexed about the level of complacency exhibited by investors; however, there were far fewer hazards to contend with at the time. Exhibits 16 and 17 illustrate the 6-month trend in domestic and global policy uncertainty. Despite the deluge of events over the last 12+ months, there has been a gradual decrescendo in both domestic and global uncertainty. However, as students of statistics, we are always watchful for inflection points. And in both cases, we see a turning of sentiment commensurate with rising uncertainty and increasing tensions here and globally.

Exhibit 16: U.S. Policy Uncertainty



Policyuncertainty.com and NEPCG

Exhibit 17: Global Policy Uncertainty



Policyuncertainty.com and NEPCG

In our opinion, topping the list of concerns investors should be wary of this year remains the Russian/Ukraine war, the most significant European conflict since WWII. At the writing of this report, the war has been raging for roughly 700 days, and while it has been recently reported by the New York Times that President Putin may be "open" to negotiating a cease-fire[11], we cannot indeed discount the motives of an autocratic leader, with seemingly no regard for humanity and even self-preservation. President Putin is expected to secure another term to at least 2030 and increase his chances to stay in power until 2036[12]. So, regardless of how the Russia/Ukraine war transpires over

[10] A black swan is an unpredictable event that is beyond what is normally expected of a situation and has potentially severe consequences.
[11] For New York Times subscribers, click HERE for link to the story
[12] CNBC – Europe Politics Article (link)

the next 12 months, it is clear that the U.S. and her allies will need to contend with Vladimir Putin for some time to come.

Next is Israel's war with Hamas, which began with Hamas staging the most coordinated attack on Israel since the Yom Kippur War of 1973. At the time of writing this report, it is estimated that over 20,000 have lost their lives after the initial terrorist attack that killed 1,200+ Israelis and abducted another 240 hostages. While this war has disrupted the political advancement made between the West, Israel, and Arab States, more importantly, it has the potential to escalate quickly with Iranian-backed forces in Lebanon, Syria, Iraq, and Yemen. While the objective (and hope) of the U.S. is to contain these types of conflicts, we fear that the Middle East is slowing becoming a tinderbox, with the potential to draw the West into the chaos of emotions and discontent associated with a region that is void of consistent security. The world first witnessed this type of geopolitical instability with the Western invasion of Iraq twenty years ago to thwart the use of weapons of mass destruction (WMDs) and remove Saddam Hussein from power. However, despite a quick conclusion, no WMDs were found, and hundreds of thousands of casualties were suffered, along with millions of Iraqi refugees. More so, this ineffective result may have helped sow the seeds of global jihadism as we now know it. This was followed ten years ago by the Syrian civil war, which created ISIS, another massive refugee crisis across Europe and witnessed the modern-day use of chemical weapons.

However, more concerning risks stemming from the Middle East include a nuclear-enabled Iran, the prospects of which have just increased. Recently, the Wall Street Journal reported that Tehran has tripled production of weapons-grade uranium following a slowdown over the Summer of 2023. And according to the same WSJ article, Iran has enough uranium to fuel three weapons. Add to this, recent reports suggest that North Korea is ramping up nuclear capability, with the commissioning of its second nuclear reactor, increasing the rate of plutonium production by 4-5 times. In addition, North Korea is growing politically closer to Russia and China, which would simply embolden the Pyongyang dictator.

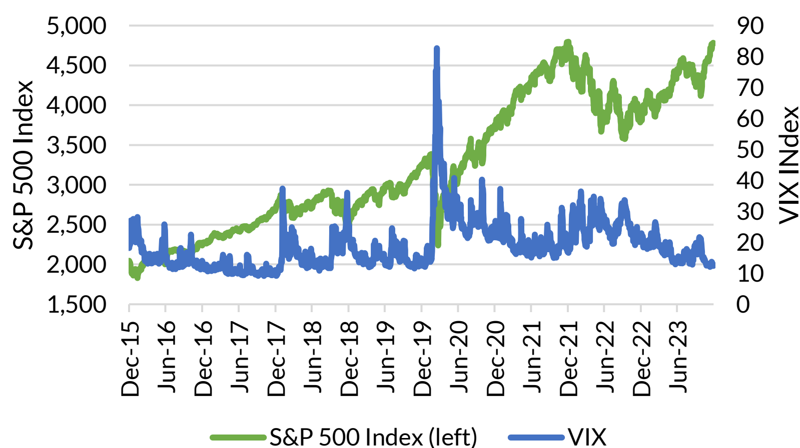
Next is the current Sino-U.S. relationship. Whether it be Technology and cybersecurity, human rights, or any potential conflict with Taiwan, the current political and economic relationship between Washington and Beijing seems to be deteriorating by the day. Most

recently, President Xi suggested that the reunification of Taiwan with China is inevitable. And the recent victory for President William Lai, a pro-sovereignty candidate, will not quell any disconnect between Beijing and Taipei.

Election Year Dynamics

Historically, risk assets and equity markets, in particular, have enjoyed robust returns during periods of limited volatility, and 2023 was no exception. Below, we illustrate this relationship more formally by looking at the VIX[13], or the CBOE Volatility Index. Exhibit 16 shows a negative correlation[14] between the VIX and the S&P 500, or in the simplest terms, a relationship between two variables, such as when one moves up, the other moves down.

Exhibit 16: VIX and the S&P 500



FactSet and NEPCG

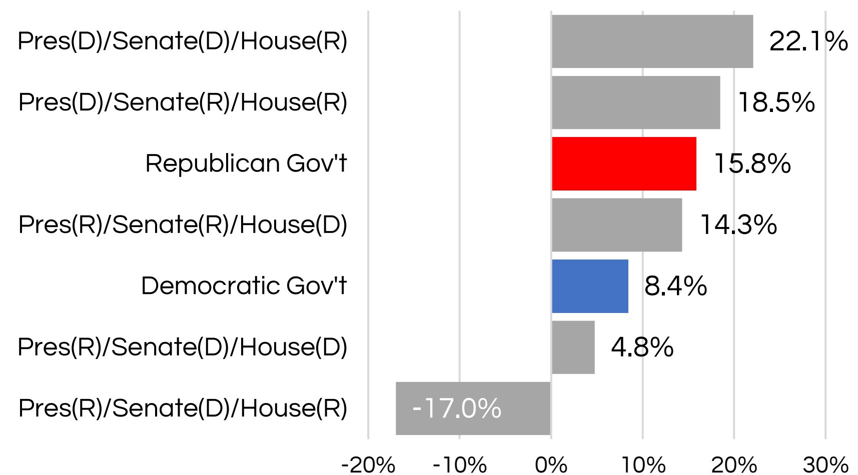
In our 2023 Outlook, we suggested that a "divided government" is a good harbinger for market returns in the coming year, which we reiterate herein. In Exhibit 17, we illustrate that based on our analysis, the two best governing outcomes for equity market returns were a Democratic President and either 1) a Democratic Senate and a Republican-controlled House, whereby the S&P increased by 22.1% over the next 12 months, or 2) an entirely Republican Congress,

[13] The VIX is a widely accepted measure of the equity market's overall volatility, employing a complicated algorithm using S&P 500 index options.
[14] Correlation, in the finance and investment industries, is a statistic that measures the degree to which two securities move in relation to each other. Correlations are used in advanced portfolio management, computed as the correlation coefficient, which has a value that must fall between -1.0 and +1.0.

whereby the S&P 500 increased by 18.5% over the ensuing 12 months.

But as we move further into 2024, the U.S. electorate will vote for a new U.S. President, whereby the incumbent is 81 years old, and the former President (his most likely opponent) is 77 years old; both of whom were already the oldest U.S. presidents on their initial inauguration date. And according to polling research conducted by AP/NORC[15], 58% of voters would be dissatisfied with Donald Trump as the Republican nominee, and 56% would be dissatisfied if President Biden gained the Democratic nomination.

Exhibit 17: Dems, the GOP, and S&P 500



FactSet and NEPCG

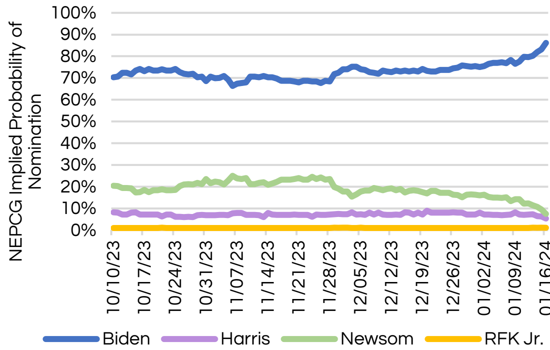
But based on data provided by Predictit.org, it is clear that the current implied probabilities, calculated by NEPCG, suggest President Biden will be the Democratic nominee, while former President Trump will be the Republican nominee.

President Biden has roughly an 86% probability of being the party's nominee, with the next closest competitor, California Governor Gavin Newson, having approximately a 7% probability. The current Vice-President, Kamala Harris, sits third at 5%, while RFK Jr is the most unlikely Democratic nominee at only 1%. Concerning Republicans (at the time of drafting this report), former President Donald Trump is slated to be the nominee with an implied probability of roughly 85%, with former U.S. Ambassador/S.C. Governor Nikki

[15] https://apnorc.org/projects/public-dissatisfied-with-biden-trump-rematch/

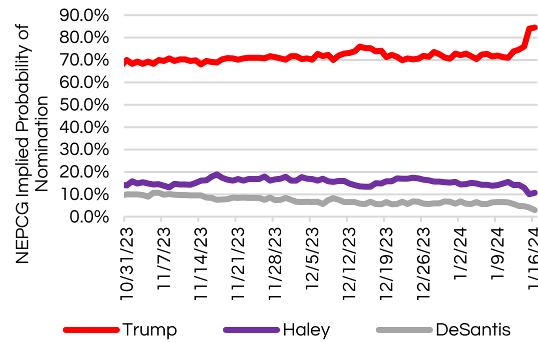
Haley in second at 10%, and Governor Ron DeSantis in third at 3%; however since then, Governor DeSantis has withdrawn from the race.

Exhibit 18: Democrat Nomination Field



FactSet and NEPCG

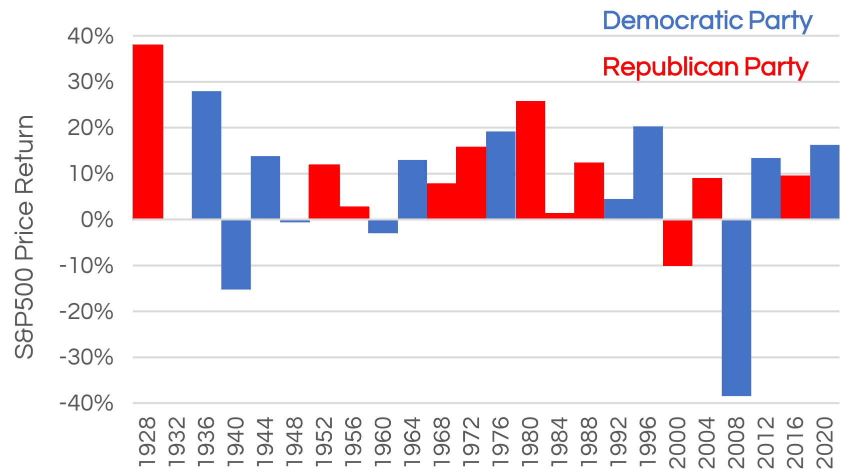
Exhibit 19: Republican Nomination Field



Federal Reserve Economic Data and NEPCG

But polls are changing by the day. Further, the ultimate constituency of Congress is also in question. When drafting this report, our research suggests that Republicans would still hold a narrow majority in the House of Representatives, with an increasing probability of Republicans retaking the Senate by a narrow margin.

Exhibit 20: S&P 500 During Presidential Election Years



FactSet and NEPCG

So, despite the never-ending posturing and politicking in Washington, DC, or the manic whims of Presidential polls, or the uncertainty regarding what party will ultimately control Congress, we found the average price-only return for the S&P 500 during an election year is about positive 7.5%.

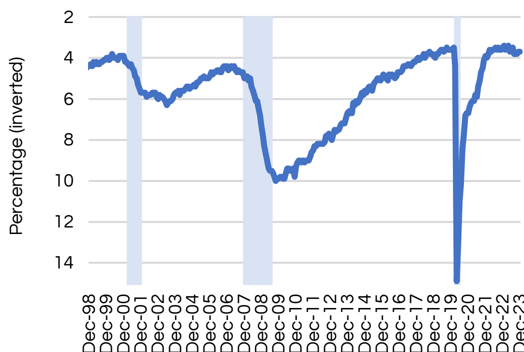
But as noted above, details matter. Drilling deeper, we found the average return for the S&P following a Democratic (Blue) victory was 4.3%, while the average return for the S&P 500 following a Republican victory was 11.2%. However, these results are significantly skewed by the Great Depression, WWII, and the Great Recession, all occurring while a Democrat was the primary occupant of the White House. If we remove these annualized return periods from the analysis, the overall average return in an election year increases to 11.8%, with a Democratic victory producing a 9.6% return and a Republican victory unchanged at 11.2%.

Economic Headwinds

Similarly to our geopolitical concerns, we are simply stunned as to how numbed investors are to mounting domestic economic headwinds.

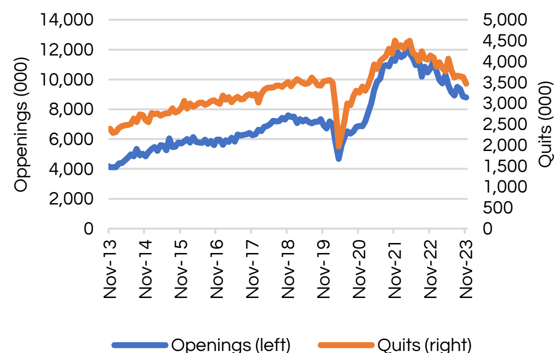
Let's start with the employment situation. Historically, economists would look to job demand and wages as the canary in the coal mine regarding just how healthy or overheated an economy is. However, we believe the economic hangover from the pandemic remains and is still sending mixed signals. We've coined the term "***resource-frugal***" to best describe an employer's current state of mind and actions in the current environment. We believe that the labor market is being sustained by hoarding labor, improved productivity through Technology, and/or employers becoming increasingly ambivalently tolerant of the experience, competency, and compensation relationship for their employees.

Exhibit 21: Unemployment Rate (Inverted)



FactSet and NEPCG

Exhibit 22: U.S. Job Openings & Quits



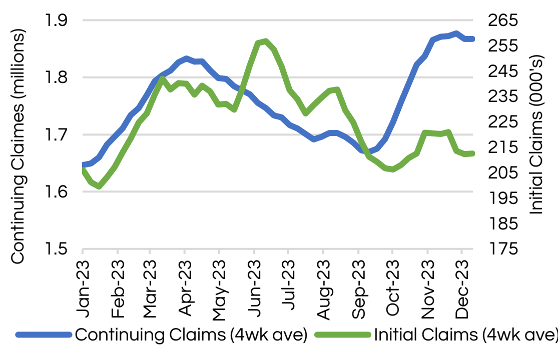
FactSet and NEPCG

Said differently, employers are trying to do more with less and, in some cases, are willing to accept sub-par performance in exchange for lower labor costs.

So, as long as monthly BLS job numbers remain at a level concurrent with population growth (~100-150k/month), the narrative from economists and strategists will remain positive. But as we drill down into data, we see cracks forming. Exhibit 21 illustrates that although the unemployment rate remains at decade lows, the overall trend seems to be rolling over. And while the recent December job results were modestly better than expectations, employment growth is being fueled by government, Healthcare, and leisure jobs. Further, Exhibit 22 illustrates that both Openings and Quits continue to roll over. As the chart indicates, the overall level of Job Openings[16] has rolled over from 12,027 in March of 2022 to 8,790 as of November 2023, down over 18% from year-ago levels. At the same time, Quits have also moderated, from 4,501 in November of 2021 to 3,471 in November 2023, down over 16% from year-ago levels. Quits are particularly useful to monitor, as conventional wisdom would suggest that individuals are only quitting jobs when there is a better offer to move to.

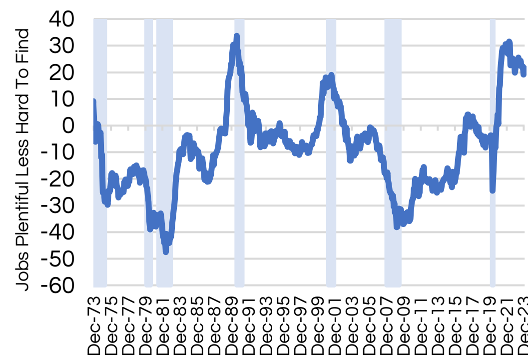
In addition, Exhibit 23 illustrates the expanding "gap" between the four-week average of both Continuing Claims and Initial Claims.

Exhibit 23: Claims: Initial vs. Continuing



FactSet, Conference Board, and NEPCG

Exhibit 24: Jobs Plentiful Less Hard To Find



Conference Board and NEPCG

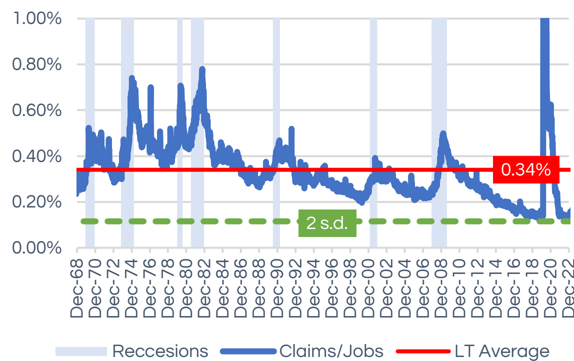
This divergence suggests that while initial unemployment claims seem resilient, laid-off workers are taking longer and longer to find a job.

[16] The Job Openings and Labor Turnover Survey (JOLTS) tells us how many job openings there are each month, how many workers were hired, how many quit their job, how many were laid off, and how many experienced other separations (which includes worker deaths).

Further, Exhibit 23 shows that according to the Conference Board, the net of jobs being "Plentiful" versus "Hard To Find" continues to soften. We note that a material reduction in this index typically accompanies a potential for recession.

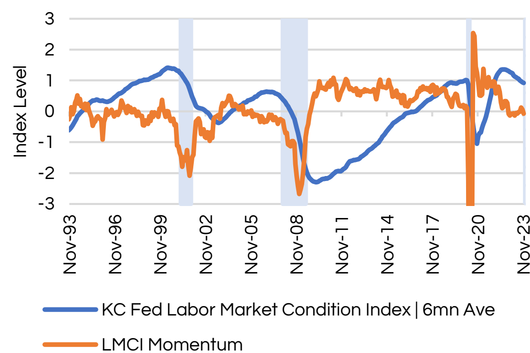
Next, in Exhibit 25, we show the overall level of unemployment claims as a percentage of the employment base. We note that the Claims/Jobs ratio is now two standard deviations wide of the long-term average of 0.34% and back to levels last seen before the COVID-19 pandemic. Further, this ratio is beginning to hook up, which was the case before/during every prior recession.

Exhibit 25: Claims As % Of Jobs



FactSet and NEPCG

Exhibit 26: K.C. Fed Labor Market Index



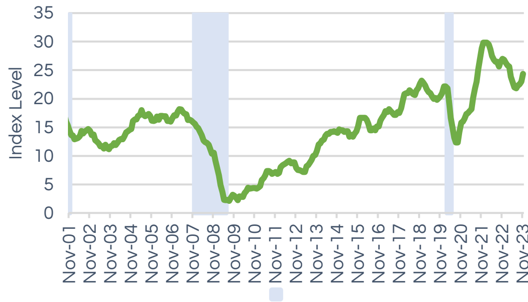
Federal Reserve Economic Data and NEPCG

Further, Exhibit 26 above illustrates that the recent trend in the Kansas City Fed's Labor Market Conditions Indicator is not reassuring. Not only is the composite 6-month trend for the 24 disparate components exhibiting softness, but the momentum of this data series also continues to bottom. Again, we note that weakening in this data series is commensurate with a recessionary backdrop.

But for optimists, we provide a potential offset to our less-than-constructive view toward the employment market. Exhibit 27 illustrates the recent trend/reading for the National Federation of Independent Business' Compensation Plans for the Next Three Months. We note that between August and November 2023, this index times series has shown positive momentum after topping back in March 2022.

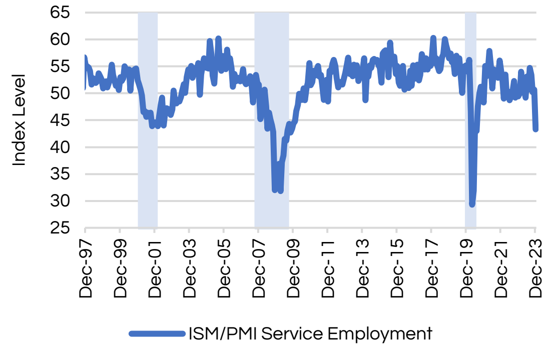
However, we believe much of this positive trend was driven by strong "service-related" employment through the back half of 2023.

Exhibit 27: NFIB Compensation Plans



NFIB and NEPCG

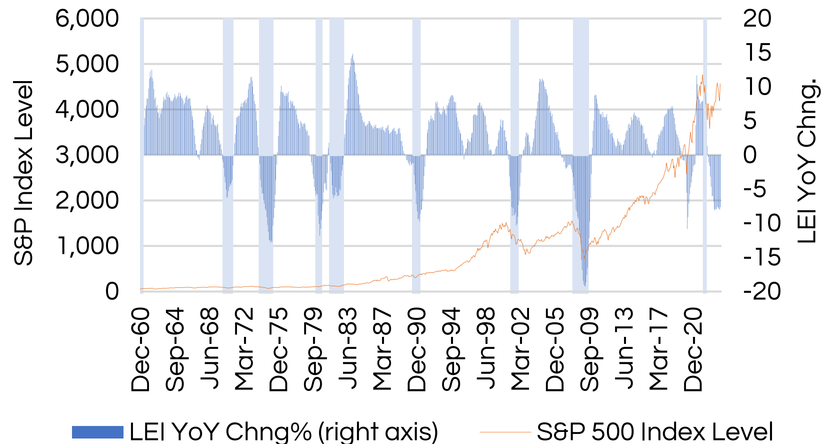
Exhibit 28: ISM/PMI Service Employment Index



Federal Reserve Economic Data and NEPCG

As illustrated in Exhibit 28, the recent trend in the ISM Service PMI for Employment[17] Index plunged in December 2023, dropping to the lowest level in nearly 3-1/2 years – suggesting, in our opinion, that service-related inflation trends are poised to reverse.

Exhibit 29: Leading Economic Indicators



Federal Reserve Economic Data and NEPCG

One of the most concerning data series we monitor is the Index of Leading Economic Indicators (LEI), published by the Conference Board. The LEI is an economic time series intended to predict economic activity by analyzing several economic trends[18]. As we

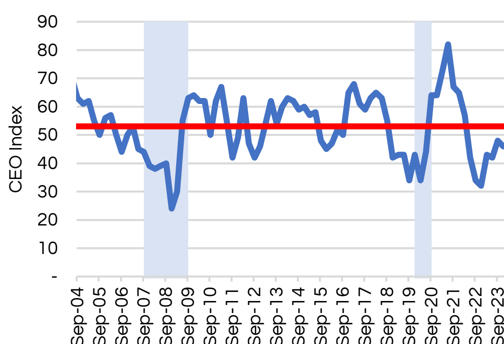
[17] https://www.reuters.com/markets/us/us-service-sector-slows-december-employment-plummets-ism-survey-2024-01-05/

[18] The ten components of The Conference Board Leading Economic Index® for the U.S. include: Average weekly hours in manufacturing; Average weekly initial claims for unemployment insurance; Manufacturers' new orders for consumer goods and materials; ISM® Index of New Orders; Manufacturers' new orders for nondefense capital goods excluding aircraft orders; Building permits for new private housing units; S&P 500® Index of Stock Prices; Leading Credit Index™; Interest rate spread (10-year Treasury bonds less federal funds rate); Average consumer expectations for business conditions.

illustrate, the year-over-year change in LEI has been negative for 20 consecutive months. Historically, there has not been a period whereby the LEI has been negative without the U.S. experiencing a recession. While some researchers suggest the pandemic-related biases and the weighing of "goods" over "services" distort the predictive ability of the LEI, we are not as convinced, especially as we note in Exhibit 28, that service-related employment trends are finally rolling over.

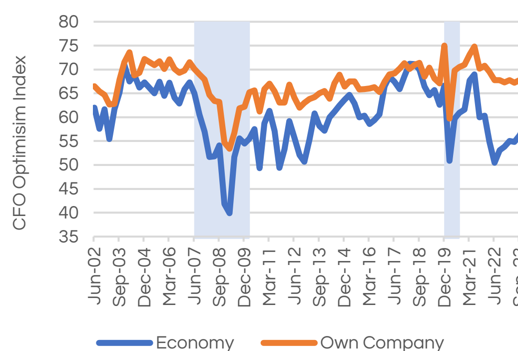
The Conference Board also surveys CEOs and publishes a quarterly survey, which we believe is sending mixed messages. The CEO Survey is intended to measure the health of the U.S. economy based on CEOs' perceptions of current and expected business/industry conditions across four key areas: capital spending, employment, recruiting, and wages.

Exhibit 30: CEO Confidence



Conference Board and NEPCG

Exhibit 31: CFO Survey

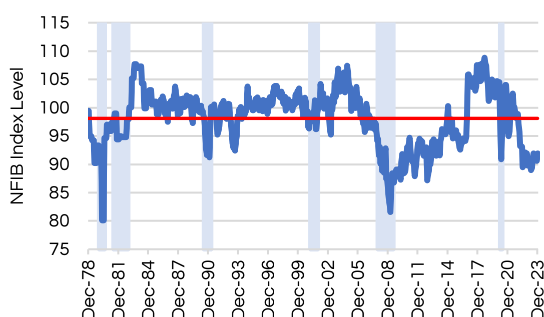


Richmond Federal Reserve and NEPCG

While the time series bottomed in 4Q22, and the recent trend has been constructive, the 4Q23 survey exhibited a modest dip, down to 46. **In addition, like most other time series surveys we are analyzing, we find that sentiment begins to "hook up" during, not following, a recession**. Further, the CEO Survey Index reading is below 50, which signifies that CEOs remain cautious regarding what's ahead for the economy. In addition, recent survey trends remain below the long-term average of 53. The Richmond Federal Reserve and the Fuqua Business School also conducted a similar survey focusing on corporate CFOs. We find these survey results fascinating. While CFOs expect a brighter future for the economy, they depict a more cautious outlook regarding their own companies' revenue, pricing, margins, and employment prospects. Further, as with the CEO

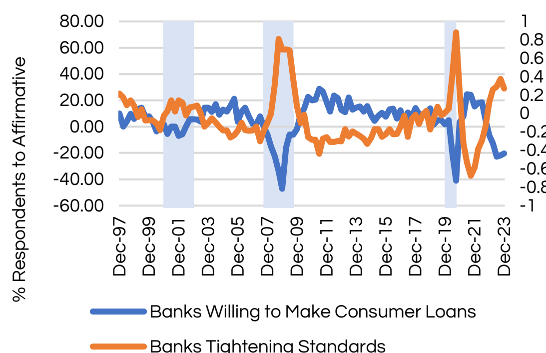
Survey, we note that CFOs have historically started to become optimistic as a business cycle is bottoming, not during an expansionary phase.

Exhibit 32: NFIB Small Business Optimism



FactSet and NEPCG

Exhibit 33: Banks' Willingness To Lend



FactSet and NEPCG

Higher rates and post-pandemic dynamics have negatively impacted prospects for small businesses. While the latest read from the National Federation of Independent Business shows modest month-over-month improvement, Exhibit 32 shows that recent trends are well below the long-term average index reading of 98. As a result, it should be no surprise that banks have become cautious in their lending activity. In Exhibit 33 above, we illustrate that banks' willingness to make loans has bottomed, while at the same time, their underwriting and lending standards remain restrictive.

Broader manufacturing trends have softened significantly since mid-2021. In Exhibit 34, we illustrate data from the Institute for Supply Management's PMI[19] survey, which provides a monthly gauge regarding the overall health of the manufacturing sector in the U.S. Following a rapid recovery after the 2020 pandemic and resulting recession, November's reading was below 50 for the 14th consecutive month, which signals economic contractions. Exhibit 35 illustrates a similar trend for global manufacturing and service PMIs with data provided by J.P. Morgan[20]. While the service component has remained above 50 for almost a year, the trend has been softening.

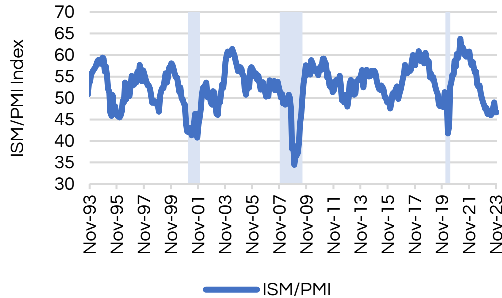
---

[19] The ISM manufacturing index, also known as the purchasing managers' index (PMI), is a monthly indicator of U.S. economic activity based on a survey of purchasing managers at more than 300 manufacturing firms. It is considered to be a key indicator of the state of the U.S. economy.

[20] The JP Morgan Global composite Purchasing Managers' Index (PMI) is an indicator of economic health for manufacturing and service sectors. The purpose of the PMI is to provide information about current business conditions to company decision makers, analysts and purchasing managers.

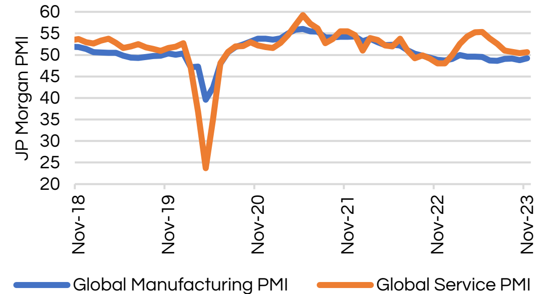
Further, the manufacturing component, much like its domestic brethren, has remained challenged and below 50 for 16 months.

Exhibit 34: ISM/PMI Manufacturing Index



FactSet and NEPCG

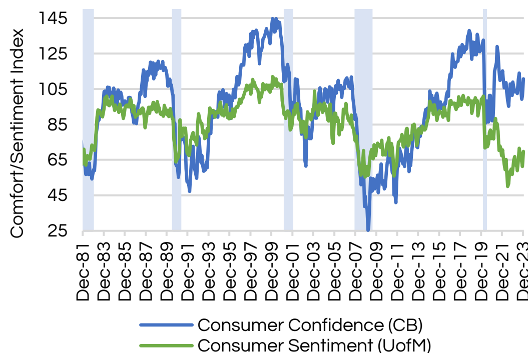
Exhibit 35: JP Morgan Global PMI



FactSet and NEPCG

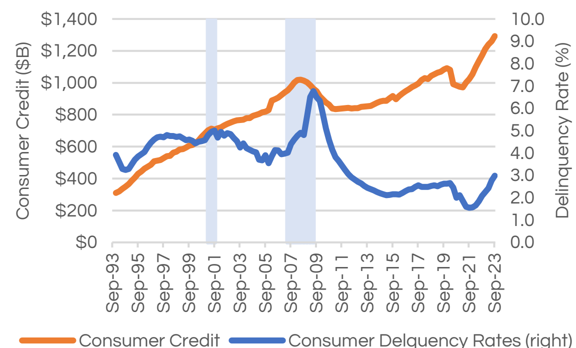
At some point, broader macroeconomic trends do impact the consumer. Exhibit 36 compares the University of Michigan's Consumer Sentiment Survey trends and the Conference Board's Consumer Confidence Survey. The Consumer Confidence survey centers on questions emphasizing employment and labor market trends, while the Consumer Sentiment survey highlights individual household finances. This suggests that the Consumer Confidence survey generally reflects consumer expectations towards the overall economy, while Consumer Sentiment reflects expectations regarding their own personal circumstances. This is a distinction without a difference, as both trends are moving in the same direction.

Exhibit 36: The Consumer



FactSet and NEPCG

Exhibit 37: Revolving Debt



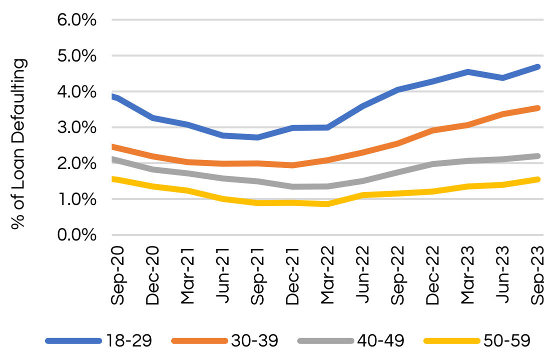
Conference Board and NEPCG

In both cases, trends have improved over the last two months of 2023, but this should **not** be surprising given the explosive move in the capital markets, the notable fall of mortgage rates, and a general

uptick in sentiment associated with a potential Fed rate cut. Remember, a consumer's two most sizable assets are typically their home and 401(k). So, improving consumer net worth should translate into a more optimistic outlook for consumers and investors.

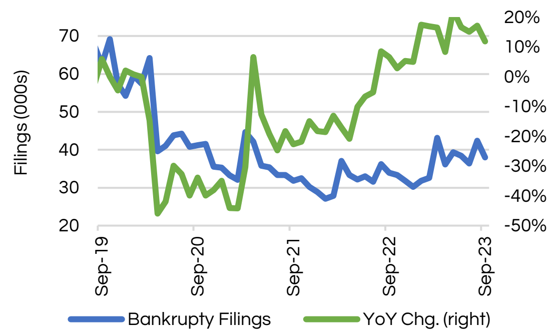
Exhibit 38 presents the most recent trends in auto-loan delinquencies (+90 days) and cohort (consumer age). We note that the 18-29 and 30-39 age cohorts seem to be struggling the most. And in Exhibit 39, we illustrate the recent trends in bankruptcy filings. While we witnessed positive trends leading into and just following the pandemic, starting in 1Q22, bankruptcies began to rise, increasing by as much as 9% year-over-year by August 2022. We believe tracking bankruptcies provides insight into corporate solvency and broader macroeconomic trends and deserves further monitoring.

Exhibit 38: Car Loan Defaults



N.Y. Federal Reserve and NEPCG

Exhibit 39: Bankruptcy Filings



FactSet and NEPCG

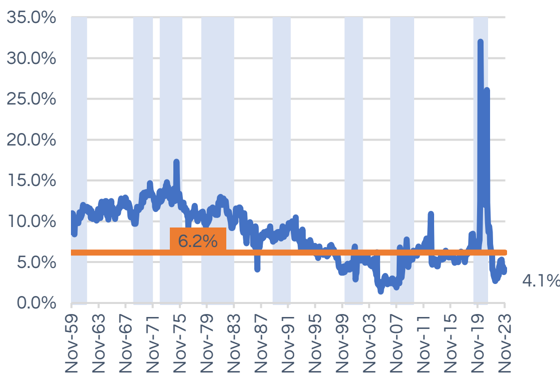
Exhibit 40 illustrates recent trends in the Monthly U.S. Domestic Savings Rate[21]. After reaching an all-time high of 32.0% in April 2020, the U.S. Savings Rate has plummeted. As of November 2023, the U.S. Savings Rate was 4.1%, a level last observed just before the Great Financial Crisis of 2008. Exhibits 40 and 41 illustrate the more recent trends in the U.S. Savings Rate. **Interestingly, savings rates have increased despite additional consumer expenditures (student loan payments, higher credit card/mortgage rates) and implied cost savings (lower gasoline/food).**

We note that historically, U.S. Savings Rate increases commensurate with recessionary pressures within the economy, acting as a buffer

[21] The U.S. personal saving rate is personal saving as a percentage of disposable personal income. In other word, it's the percentage of people's incomes left after they pay taxes and spend money.

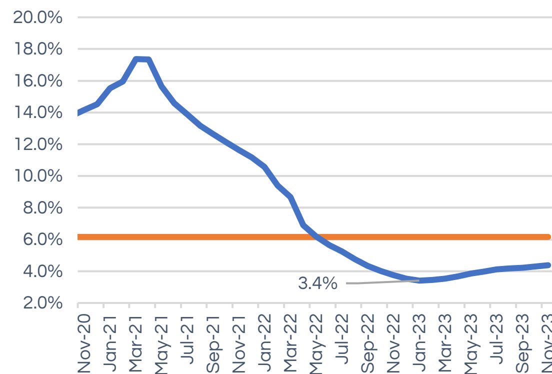
against asset value devaluation, job losses, and a lower overall perception of consumer confidence. And given our belief that most consumers have exhausted much of their pandemic-related savings, consumers will become more austere, start borrowing more, and potentially drive the Savings Rate even higher in the months ahead.

Exhibit 40: Long-Term U.S. Savings Rate



FactSet and NEPCG

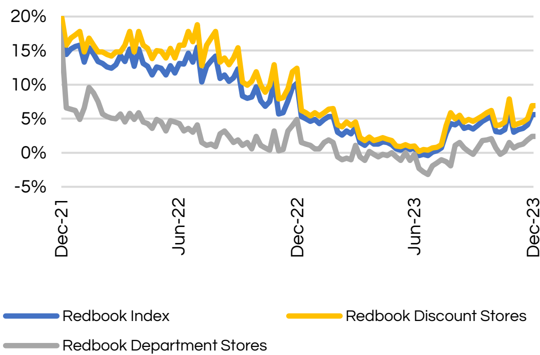
Exhibit 41: Recent Trends U.S. Savings Rate



FactSet and NEPCG

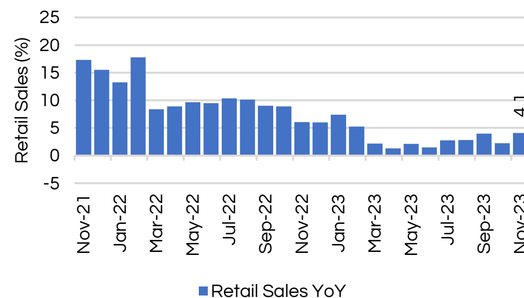
While discretionary sectors, especially those in the leisure and hospitality segments of the economy, have continued to thrive in recent quarters, we believe this optimism is a function of prior bookings, reservations, and revenge spending[22].

Exhibit 42: Retail Sales



FactSet and NEPCG

Exhibit 43: Redbook Retail Sales



FactSet and NEPCG

But despite all the concerns we have unpacked to this point, the U.S. consumer has remained a port in a sea of uncertainty. We discuss the reasoning for this shortly, but Exhibit 42 illustrates data compiled by RedBook. Redbook Indices track sales-weighted, year-over-year

[22] Refers to a sudden surge in the purchase of consumer goods after people are denied the opportunity to shop for extended periods of time.

same-store sales growth across a large sample of large U.S. general merchandise retailers representing about 9,000 discount and department stores. Despite our concerns regarding the consumer, spending remains solid. Further, Exhibit 43 illustrates the recent year-over-year trends in U.S. Retail Sales, released monthly by the Commerce Department. Following relatively solid growth for much of 2022, retailers exhibited some softness through 3Q23. However, the 2023 Holiday season posted a 3.1% increase from 2022, helping propel November retail sales by 4.1% versus 2022. Still, we caution investors that we feel the till is running dry regarding pent-up savings and demand.

Capital Market Outlook

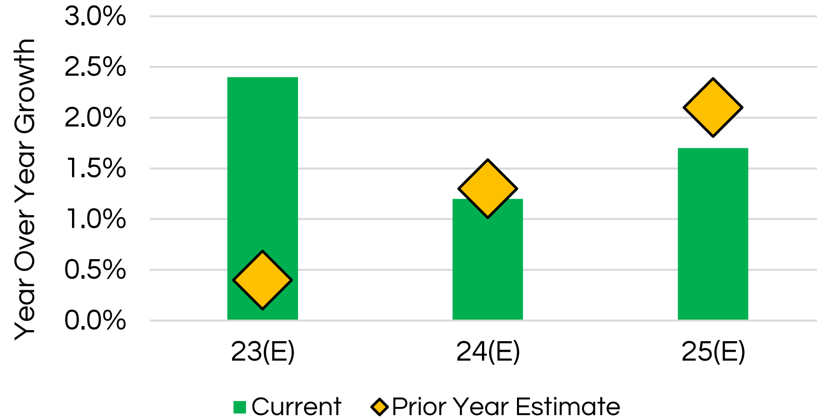
Hope Is Not A Strategy

Still Expecting A Slowdown (aka Recession)

Over the last 12 months, several pundits and analysts (including ourselves) have underestimated the resilience of the U.S. consumer, the health of U.S. corporations, and the tenacity of the equity markets. In hindsight, the impetus for the positive surprise is apparent, in our opinion.

First, concerning the consumer, pent-up savings and "resource frugal" employers helped sustain spending and kept the labor market sound. In addition, mobility among homeowners was limited, given the rise in interest rates. The silver lining was that many existing homeowners had used generationally low mortgage rates into and following the COVID-19 pandemic to reduce debt-service costs on what is presumably, for many, their largest financed asset. Similarly, corporations have used the last several years to term out high-cost debt, helping boost earnings either through share buy-backs or simply higher net income. As a result, the long-awaited 2023 recession "seemingly" never manifested, resulting in a re-rating of near-term U.S. growth prospects to the upside and several Wall Street pundits to walk up year-end targets.

Exhibit 44: Consensus GDP Growth Expectations

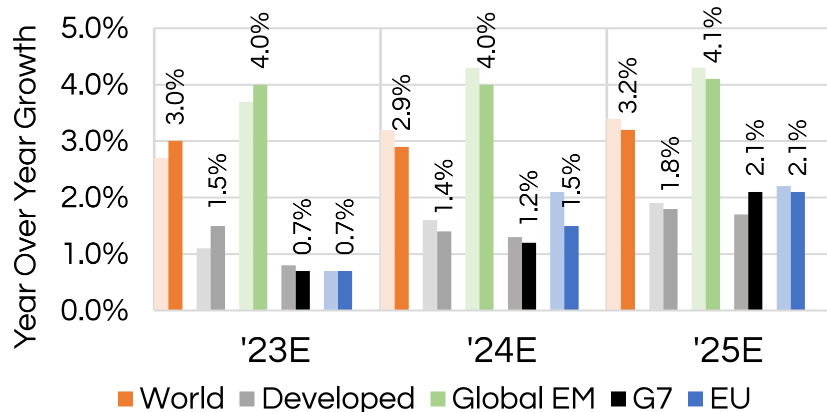


FactSet and FactSet consensus estimates as indicated by (E)

However, as we illustrate in Exhibit 44, we show that forward GDP expectations are being tempered. The current FactSet consensus expectation for 2024 Real GDP growth in the U.S. is now 1.2%, below the 1.3% we published in our 2023 Outlook. Similarly, the FactSet consensus estimate for 2025 Real GDP growth is now 1.7%, versus 2.1% from twelve months ago.

Globally, we notice similar re-ratings for GDP growth prospects. Exhibit 45 illustrates that global economies expect lower sequential growth prospects through 2024.

Exhibit 45: Global GDP Growth Expectations



IMF estimates, as indicated by (E)

Each economic region's lighter shade/hue represents the International Monetary Fund's prior estimate of real GDP, whereas

the darker shade/hue represents the IMF's current expectations. Like the U.S., we observe a reduction in current and prior estimates for 2024 growth across most economic regions.

And although Global Emerging Market economies are expected to exhibit flat year-over-year growth in 2024, the prior expectation for 2024 was about 30bps higher at 4.3%. Finally, a revision worth closer attention is Europe (E.U.). While Europe remains in the crosshairs of a war, its growth prospects are expected to improve over the next two years.

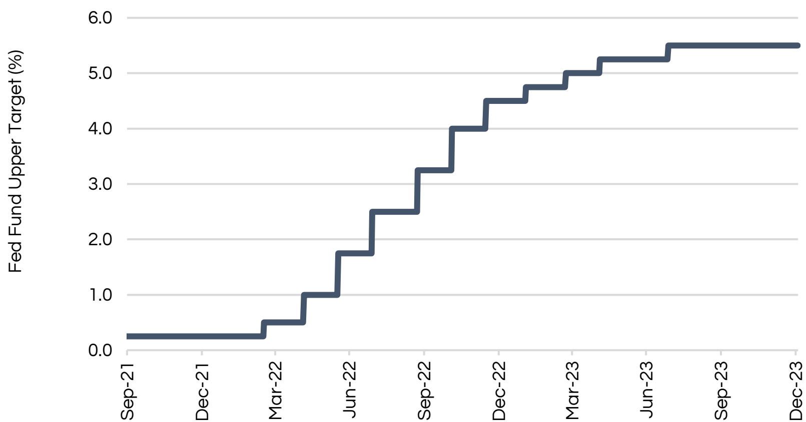
Up to this point, we have argued that current economic headwinds are being ignored, especially if one juxtaposes that thesis against recent equity and fixed-income capital market trends. **For those genuinely reading between the lines, we are suggesting that the recession that most of Wall Street was expecting at the onset of 2023 has finally arrived.**

Inflation, Interest Rates, And Recession Expectations

Needing More Than Just Immaculate Disinflation

The COVID-19 pandemic required severe policy decisions, which validated an aggressive FOMC easing cycle. However, as we suggested in our 2022 Outlook, the FOMC would ultimately find itself behind the eight-ball, raising rates too late and resulting in a potential policy mistake.

Exhibit 46: 2022-2023 Interest Rate Cycle

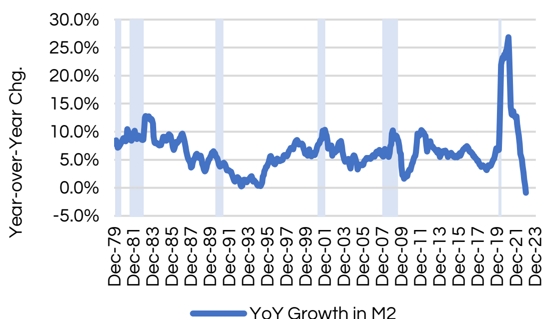


FactSet and NEPCG

Following the pandemic, policymakers and central bankers worldwide took unprecedented steps to resuscitate a faltering global economy. In the U.S., the Federal Reserve continued with Quantitative Easing[23], an atypical monetary policy intended to support market liquidity and lower borrowing costs. The overall monetary policy response resulted in an 80% increase in the Fed's balance sheet to almost $9 trillion, while M2 [24] grew by nearly 27%. As a result, consumers and businesses found themselves awash with liquidity, and thus, the seeds of inflation were sown.

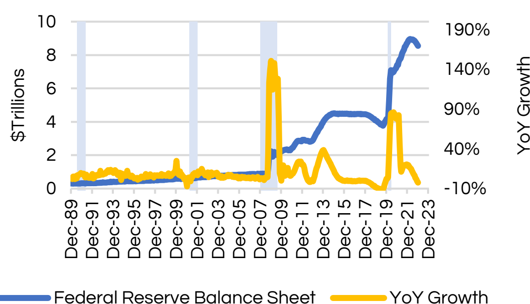
We believe the period between late 2021 and early 2022 could be characterized as a "perfect inflation storm," whereby cost-push and demand-pull forces simultaneously worked within the U.S. economy.

Exhibit 47: M2 Growth



FactSet and NEPCG

Exhibit 48: Federal Reserve Balance Sheet



FactSet and NEPCG

As previously mentioned, our 2022 Outlook suggested that the Federal Reserve Open Market Committee (FOMC) was on the verge of yet another policy mistake. We feared that any subsequent normalization of interest rates would be too dovish regarding timing and scale. And unless the FOMC moved with intent, the result would be soaring inflation, a challenging economic backdrop, and potentially negative capital market returns. Exhibit 49 illustrates the current rate hike cycle compared to the last seven hiking cycles that ultimately ended with a recession. We established a baseline for our analysis dating back 18 months from the official start of each NBER-

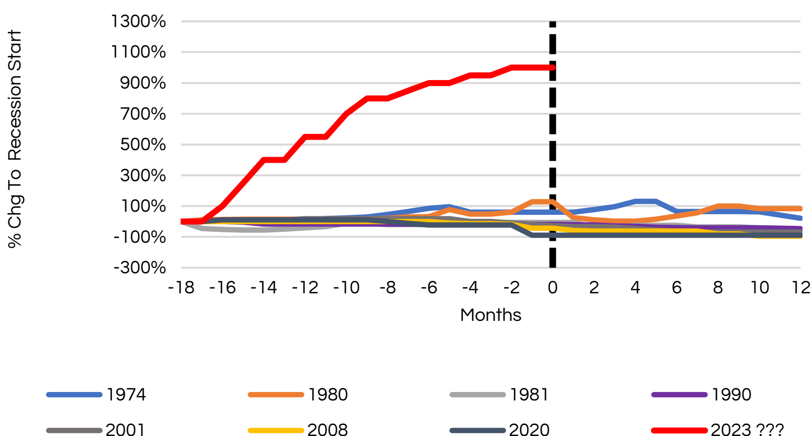
---

[2323] Quantitative easing (QE) is a form of monetary policy in which a central bank, like the U.S. Federal Reserve, purchases securities from the open market to reduce interest rates and increase the money supply.

[24] M2 is a measure of the money supply that includes cash, checking deposits, and other types of deposits that are readily convertible to cash such as CDs. M1 is an estimate of cash and checking account deposits only. The weekly M2 and M1 numbers are closely monitored as indicators of the overall money supply.

acknowledged recession. Exhibit 49 also indicates the ***current*** upper target range for Fed Funds (5.5%).

Exhibit 49: Rate Hike Comparison



FactSet and NEPCG

This data implies that the FOMC has increased rates by 1,000% ***since*** its first rate move in March 2022.

Fast forward 24 months, we find that due to a delayed policy reaction, the FOMC embarked on the most aggressive rate-tightening campaign since the Volcker years[25]. Assuming the July 2023 hike is the last in the current cycle, history will show the FOMC increased its target rate 11 times from an upper range of 25bps to 5.5% over the course of 18 months, attempting to quell inflation levels not seen in 40 years.

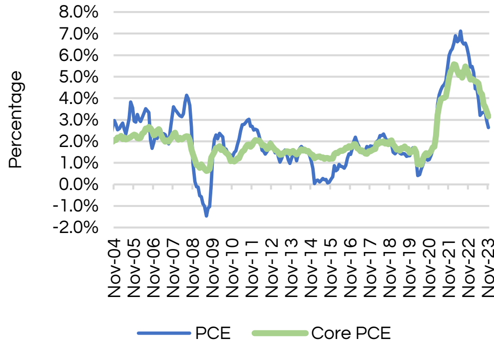
But as on the way up, so as on the way down, we believe the response lag[26] embedded into such unprecedented monetary policy moves may potentially trigger a policy mistake in keeping interest rates too high for too long.

Exhibit 50 compares the year-over-year growth in Personal Consumption Expenditures (PCE), the preferred Federal Reserve measure to gauge inflation, and the "core" measure, which removes the impact of volatile food and energy prices.

[25] Paul Volcker (September 5, 1927 – December 8, 2019) was an American economist who served as the 12th chairman of the Federal Reserve from 1979 to 1987. During his tenure as chairman, Volcker was widely credited with having ended the high levels of inflation seen in the United States throughout the 1970s and early 1980s.

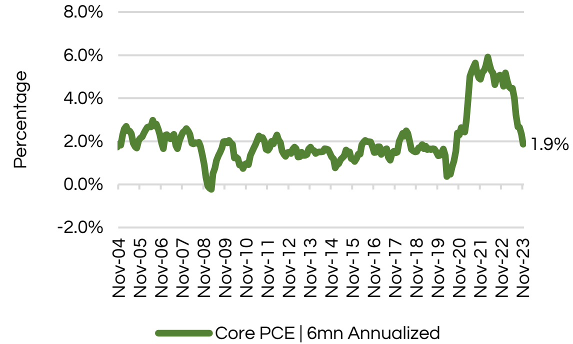
[26] Response lag, also known as impact lag, is the time it takes for monetary and fiscal policies, designed to smooth out the economic cycle or respond to an adverse economic event, to affect the economy once they have been implemented.

Exhibit 50: PCE Growth



FactSet and NEPCG

Exhibit 51: Trailing 6-Month PCE



FactSet and NEPCG

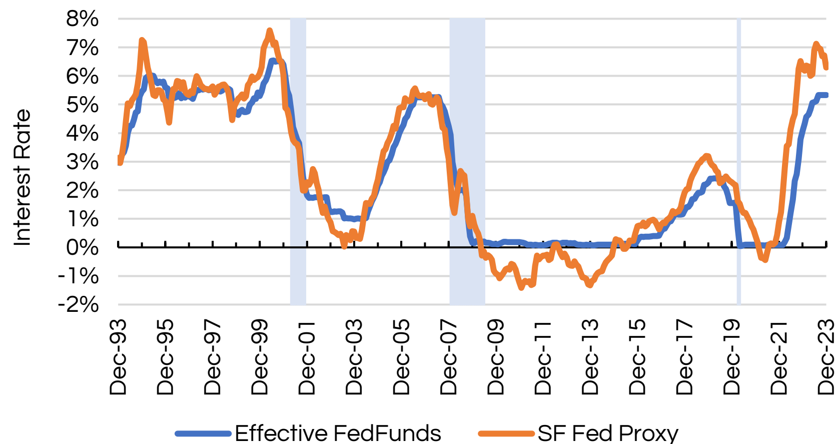
The data series illustrates that nominal and core PCE peaked in June 2022 and February 2022, respectively. As of November 2023, these two measures registered 3.2% and 2.4% above the FOMC's preferred inflation rate of 2%. However, Exhibit 51 illustrates that the annualized rate of core PCE growth over the last six months is only 1.9%. Therefore, from our perspective, inflation, for the most part, is well on its way to the Fed's preferred level of 2%

Moving forward, we would not be surprised to see inflation fall more dramatically than the consensus expectations. In much the same way that the combined impact of demand-pull and cost-push factors turbocharged inflation to the upside, the compound removal of these forces could have the opposite impact.

--2023 Outlook

Finally, Exhibit 52 compares the San Francisco Fed Proxy Rate to the effective Fed Funds rate from 1992.

Exhibit 52: San Francisco Fed Rate Proxy



FactSet and NEPCG

The San Francisco Federal Reserve's Proxy Funds Rate can best be interpreted as the prevailing effective Federal Funds rate, void of any monetary or fiscal policy stimulus. In other words, this proxy rate attempts to eliminate the impact that Quantitative

Easing/Quantitative Tightening may have had on the nominal Fed Funds rate. Exhibit 52 shows that the "true" Fed Fund rate may be as high as 6.3%, implying a monetary stance over 100bps more restrictive than the current nominal Fed Fund rate.

Taken in aggregate, we believe these inflation analyses infer that the FOMC may have already tightened financial conditions enough to combat run-away inflation prospects, and as we postulated in our 2023 Outlook, inflation would be falling as quickly as it rose. Further, we believe that much, if not all, of the current cycle's tightening has already occurred. Therefore, we believe the FOMC is again playing with fire by maintaining a policy that is too restrictive.

As previously mentioned, at the end of 2023, market participants were assigning almost a 90% probability of rate cuts in 2024 while pricing in a weighted average Fed Funds rate of roughly 450bps by the July FOMC meeting. In Exhibit 52, we replicate a probability matrix with data from the CME Group. The CME Group constructs and publishes its CME FedWatch Tool, which helps investors analyze and determine the future path of interest rates.

At the time of drafting this report, the market (as implied by the CME FedWatch Tool) was pricing an effective terminal rate[27] for Fed Funds of roughly 415bps by July 2024, roughly 135bps lower than the current upper limit. More alarming, these probabilities imply at least a 25bps cut in four of the next five meetings and potentially a 50bps cut in the fifth.

Exhibit 52: Rate Hike Probabilities

		CME Market Expected Fed Fund Rate Levels @ Meeting Date											
	Meeting Date	3.25%	3.50%	3.75%	4.00%	4.25%	4.50%	4.75%	5.00%	5.25%	5.50%	Wgt. Rate	Prob Cut
Probailbity	1/31/24	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	4.7%	95.3%	5.49%	5%
	3/20/24	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	3.3%	70.0%	26.7%	5.31%	73%
	5/1/24	0.0%	0.0%	0.0%	0.0%	0.0%	0.2%	7.4%	67.3%	25.1%	0.0%	5.04%	100%
	6/12/24	0.0%	0.0%	0.0%	0.1%	2.0%	22.1%	56.9%	18.9%	0.0%	0.0%	4.73%	100%
	7/31/24	0.0%	0.0%	0.1%	2.6%	23.3%	55.7%	18.3%	0.0%	0.0%	0.0%	4.47%	100%
	9/18/24	0.0%	0.1%	2.6%	22.9%	55.0%	19.0%	0.4%	0.0%	0.0%	0.0%	4.23%	100%
	11/7/24	0.1%	1.7%	15.3%	43.1%	32.4%	7.3%	0.1%	0.0%	0.0%	0.0%	4.07%	100%
	12/18/24	1.4%	12.6%	37.6%	34.5%	12.3%	1.6%	0.0%	0.0%	0.0%	0.0%	3.87%	100%

CME and NEPCG as of 1/15/2024

[27] The terminal rate is the rate that's equal to the neutral rate so that the economy is in stable equilibrium.

While we always believed the Fed's vector regarding rate increases was too muted in late 2021 and early 2022, we now also believe that the market may be too aggressive in rate-cut expectations.

Our Recession Obsession

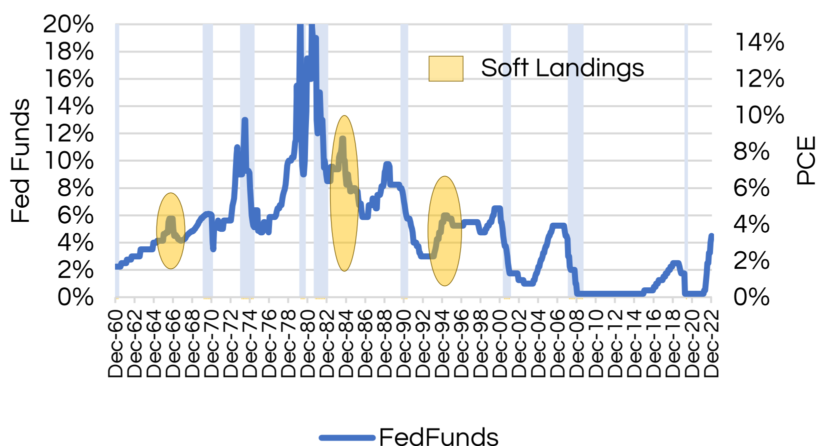
"Still, we believe the US economy is in a strong position relative to prior tightening cycles and/or pre-recession periods. As such, if a "soft landing" is not achievable, we believe the next recession will be shallow and short compared to the typical peak-to-trough duration, which averaged about 11 months (post WWII). Therefore, if a recession were to manifest itself within the next 12 months, we believe the duration could be as little as 6-9 months. The implications for capital market positioning are further discussed in the following sections."

*– **2022 Outlook***

As we have suggested, we believe the U.S. has already entered the next recession, a prognostication we do not take lightly. But dating as far back as our 2022 Outlook, we had stated the next downturn would be shallow and short. We reiterate this view (assuming no idiosyncratic events in the near term) and acknowledge we remain in the minority. In the following text, we share several surveys, data, and research that help support our thesis.

But first, let's start with the consensus view that the U.S. will either avert a recession altogether or muddle through a "soft landing." Like a unicorn, this argument is hard for us to fathom. We have read countless articles and research papers[28] suggesting a soft landing is simply a fallacy for varying reasons.

Exhibit 53: Soft Landings & Unicorns



FactSet, Alger and NEPCG

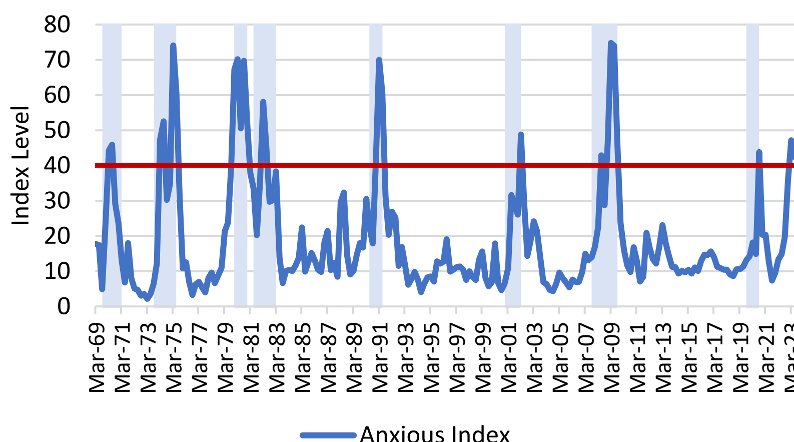
The National Bureau of Economic Research (NBER) is the official arbiter in determining if the U.S. is in a recession. To do this, the NBER analyzes several key economic indicators and trends, not just GDP. Most significant, we believe, are labor market data and the overall level of U.S. aggregate demand. And while history does show a few instances in which a "technical recession" is avoided, the odds are about 1 in 4. But this would require that the Federal Reserve acts

[28] A Soft Landing, June 23, 2000 by Robert Samuelson, Desperately Seeking A Soft Landing, June 20, 2023 by Louis Ashworth, A 'Soft Landing' Scenario - Possibility Or Fed Myth?, January 29, 2023 by Lance Roberts, The fairy tale of a soft landing, November 23, 2023, by Arif Husain, The Boundless Foolishness Underlying 'Soft Landing' Mythology, September 23, 2023, by John Tamny, The "Soft Landing" Fallacy, December 29, 2023, by Jason Nuridjanian. Looking at the Economic Myth of the "Soft Landing", November 12, 2022, by Frank Shostak.

swiftly, with foresight, to raise interest rates enough to retard growth, restrain inflation and avert a recession. However, given the evidence we present in our 2024 Outlook thus far, we believe that probability remains in line with history at about 25%. Exhibit 53 above illustrates the last twelve periods of economic weakness or recession following a rise in borrowing rates (Federal Funds). We found that in only three (3) instances, the FOMC successfully navigated a soft touchdown without the NBER officially calling a recession.

But as Exhibit 54 illustrates, a recession shortly follows when the Philadelphia Federal Reserve Anxious Index breaches 40. In fact, according to the data, this index has accurately predicted every recession identified by the National Bureau of Economic Research (NBER) since 1970.

Exhibit 54: Philly Fed Anxious Index



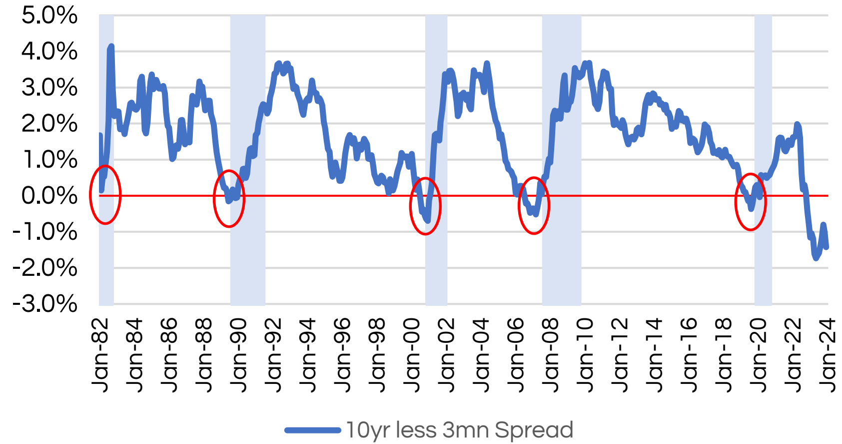
Philadelphia Federal Reserve and NEPCG

By way of background, the Anxious Index is part of The Survey of Professional Forecasters, which is the oldest quarterly survey of macroeconomic forecasts in the United States. The survey began in 1968 and was initially conducted by the American Statistical Association and the National Bureau of Economic Research. The Federal Reserve Bank of Philadelphia took over the survey in 1990. The most recent reading for the Anxious Index was 41, which is about 12% lower than the year-ago result but 20% higher than the 4Q23 level.

Adding to our recession call is the ongoing negative spread between the 10-year Treasury Note and the 3-Month Treasury Bill. In Exhibit 55, we illustrate that in every instance dating back through 1982, a

negative spread between the 10-year Treasury Note and the 3-month Treasury Bill is soon followed by a recession. This spread has been negative for roughly 325 days, significantly longer than any of the prior five recessions.

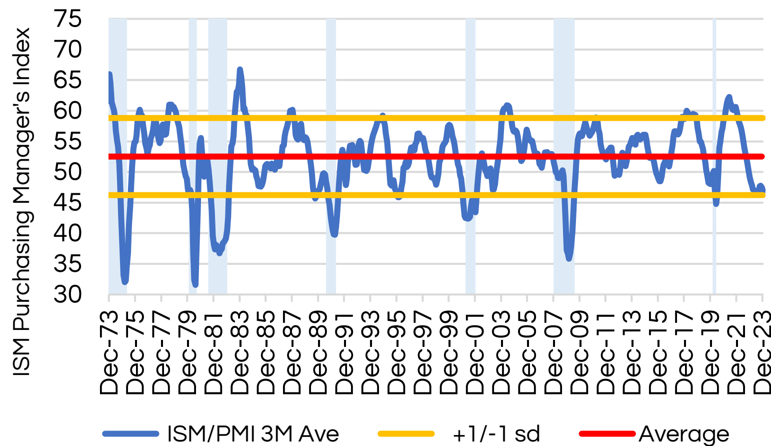
Exhibit 55: 10Yr Treasury Less 3 Month Treasury Spread



FactSet and NEPCG

In addition, we are watching the Institute for Supply Management's Purchasing Manager's Index for additional recession validation. Exhibit 56 shows that the U.S. almost always enters a recession whenever the 3-month average PMI level reaches one standard deviation below its long-term average of 52.5.

Exhibit 56: ISM Recession Indicator

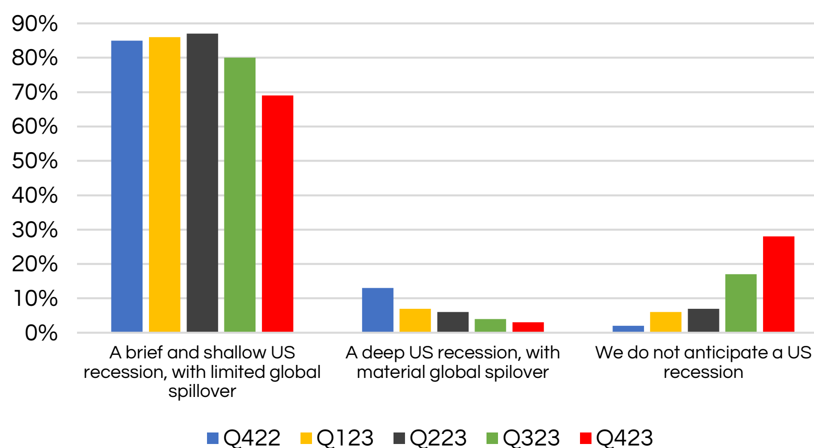


FactSet and NEPCG

Exhibit 57 presents the recent trend in the Conference Board's CEO Survey. Based on the most recent survey results (4Q23), 28% of

respondents now believe the U.S. will avoid a recession altogether, while 69% still think a "brief and shallow" recession is coming. This compares to 17% and 80% at the end of 3Q23, respectively. In our opinion, these expectations align with our prognostication, calling for a definitive but shallow recession.

Exhibit 57: Recession Expectations



Conference Board and NEPCG

Finally, although we believe the economic data presented thus far in this report helps support our overall "recession thesis," we further supplement our position based on a research paper by Kevin Kliesen published in 2003[29]. Mr. Kliesen is a business economist and research officer at the Federal Reserve Bank of St. Louis. In his 2003 paper, he researched characteristics of recessions dating back to the post-WWII recession of November 1948. Based on that research, along with our updated analysis, we believe:

1. Expansions are getting longer, averaging only 36 months pre-WWII to over 56 months post-WWII (56% longer).
2. Contractions have gotten shorter, from 21 months pre-WWII to a little over 13 months post-WWII (38% shorter).
3. The deeper the recession, the stronger the recovery.
4. The milder the recession, the milder the recovery.
5. The longer the recovery, the shorter the recession.

How exactly does this support our view? We are now about to introduce an even more contentious proposition; **we believe if the COVID-19 pandemic was averted altogether, we doubt the U.S.**

[29] The 2001 Recession: How Was It Different and What Developments May Have Caused It?

would have entered a recession in 2020 and thus end the longest U.S. expansion (128 months).

Specifically, Kliesen's research finds that the three (3) most prolonged expansion phases (as of 2003) were between March 1991-March 2001 (120 months), February 1961-December 1969 (106 months), and November 1982-July 1990 (92 months). During these extended periods of economic expansion, the economic resilience exhibited through the ensuing recession was stronger than typically observed. During these three instances, the average change in Real Gross Domestic Product was only -0.9%, compared to the average of other post-WWII recessions of -2.6%. Kliesen's research further uncovered that the change in non-farm payrolls dropped by only 1.5% during these three periods, while the average of other post-WWII recessions was -3.2%. Finally, the Unemployment Rate (U3) increased by only 253bps, on average, following the three longest expansions, whereas the others averaged 350bps. Moreover, the moderate recession following the three longest expansions was only 9 months, versus the average post-WWII period in Kliesen's work of 11 months and our longer-term estimate of 13 months.

Our results become even more compelling when including the 2007-2009 recession. We remind readers that the prior expansion leading into the 2007-2009 recession was only 73 months, slightly greater than the long-term average but well below the previous top-three expansion periods. When including 2007-2009 into our "other post-WWII data set[30]," we observe that Real GDP fell by 2.8%, non-farm payrolls increased by 3.6%, and the unemployment rate increased by 360bps.

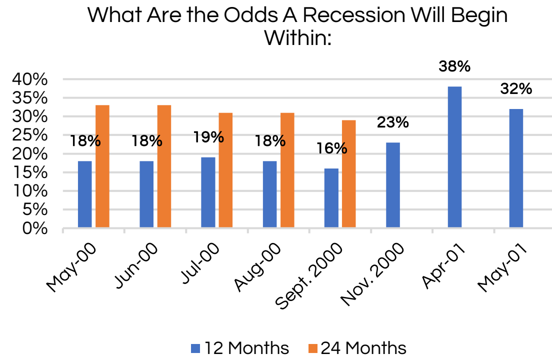
It is difficult to estimate when recessions start and stop. Even leading into the 2001 recession, forecasters[31] were found to be wrong. As we illustrate in Exhibit 58 and Exhibit 59, Kliesen found that by the end of the Summer of 2000, economic forecasts estimated the probability of a recession in the next 12 months was only 18%, and by May 2001, this estimate ticked up to 32%. However, as of September 10, 2001, only 13% of forecasters believed the U.S. had slipped into a recession;

[30] In other words, the'07-'09 recession was part of the "non-top" three recessions, as the lead-up expansion was only 73 months.

[31] Blue Chip Economic Indicators (BCEI). BCEI is a is a monthly survey and associated publication by Wolters Kluwer collecting macroeconomic forecasts related to the economy of the United States. The survey polls America's top business economists, collecting their forecasts of U.S. economic growth, inflation, interest rates, and a host of other critical indicators of future business activity.

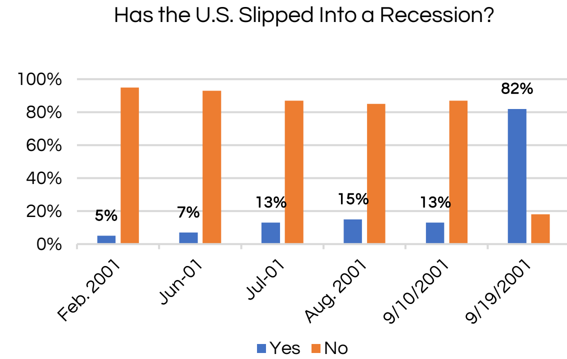
by September 19, 2001, this statistic increased to 82%. **We believe the moral of the story is that everything is good until it is not.**

Exhibit 58: 2001 Recession Forecasts



Blue Chip Economic Indicators, FRB of St. Louis

Exhibit 59: 2001 Recession Survey

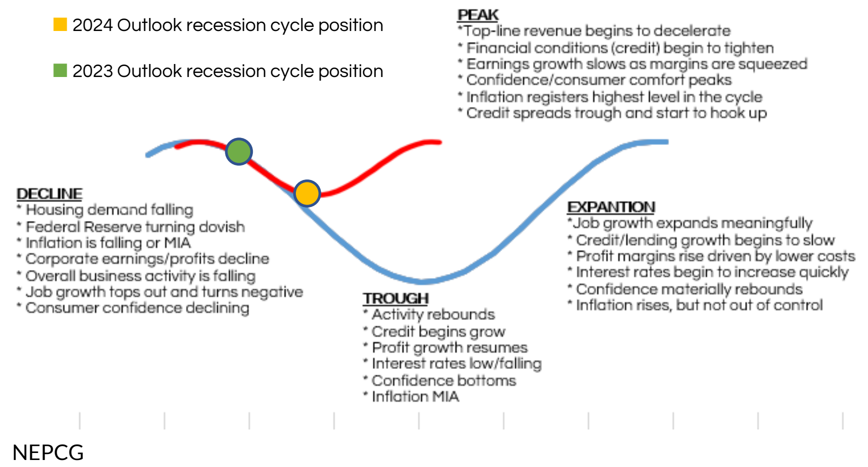


Blue Chip Economic Indicators, FRB of St. Louis

Further, we believe **barring the COVID-19/2020 Recession, the last expansion might have been between 130-160 months in duration, helped in no small part by generationally low-interest rates, as well as Kliesen's thesis regarding the ferocity of an expansion following the Great Financial Crisis of 2007-2009 (the deeper the recession, the stronger the recovery).**

Finally, in Exhibit 60, we estimate where we believe the U.S. economy is relative to the current recession cycle/prognostication. We also indicated where we felt the U.S. economy was when publishing the 2023 Outlook.

Exhibit 60: Typical Economic Life Cycle



NEPCG

2024 Positioning

Bullish On Yields & Defensive Growth

Our readers continue to hear us say, "Bonds see around corners." While equity analysts would indeed find an exception to this, we believe fixed-income managers typically need to better understand and react to credit concerns and considerations to help protect bond investors against default. But understanding credit also helps position equity portfolios.

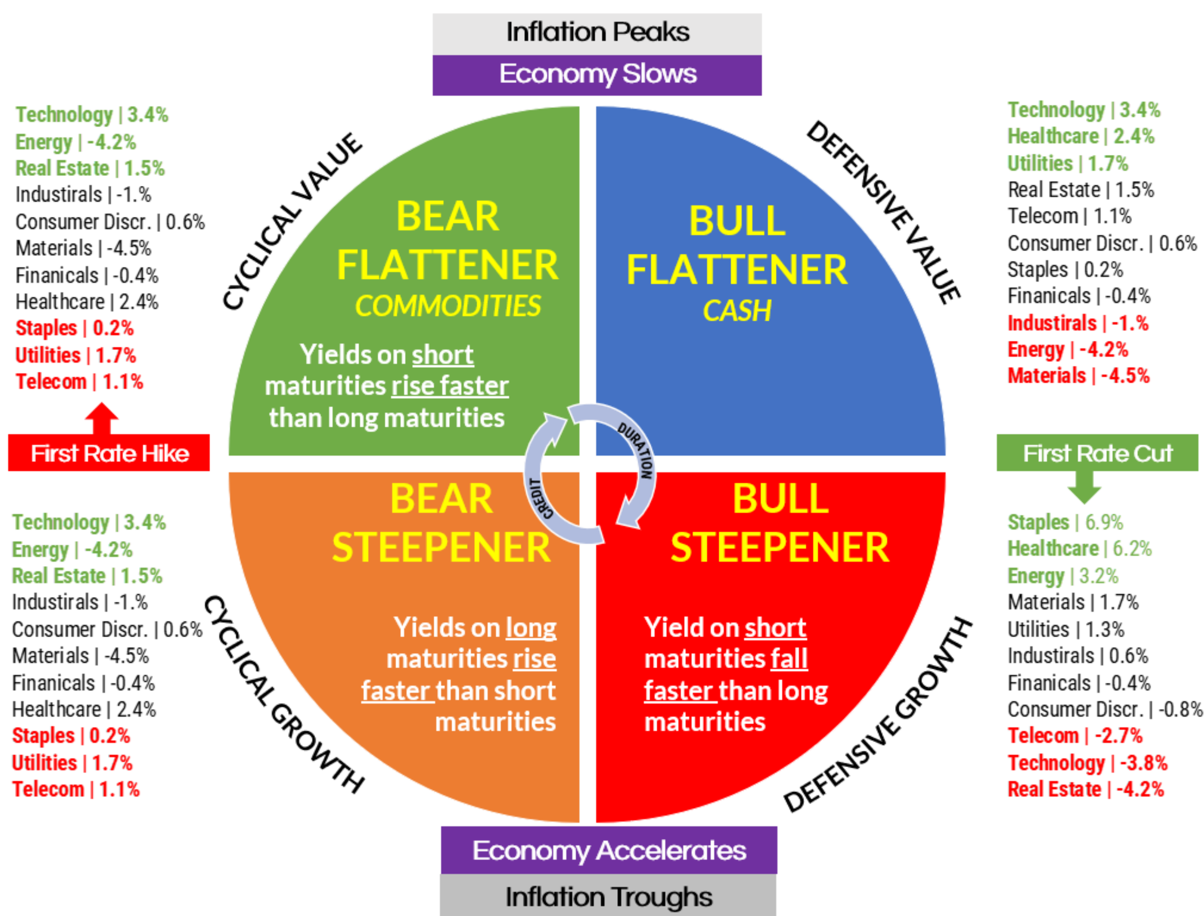
In our 2020 Outlook entitled, "What Goes Up," we introduced our **Interest Rate Regime** paradigm, which we review herein. In our opinion, by understanding historical relationships between bond prices and yields, aka the yield curve [32], we can help better understand economic and capital market trends. But first, we need to review each of the four interest rate regimes: Bull Flattener, Bull Steepener, Bear Steepener, and Bear Flattener.

In a **Bull Flattener** (blue-shaded area), yields on long-maturity bonds fall faster (price increases quicker) than yields on shorter-maturity bonds (prices increase slower). This historically happens after inflation peaks and the economy begins to slow. At the same time, central banks become more dovish[33], ultimately leading to the cycle's first-rate cut.

During these periods, we find that defensive-oriented equities tend to perform well, led by Utilities, Staples, and Real Estate (later in the cycle). While underperforming sectors typically include Materials, Financial Services, and the Energy complex (removing any idiosyncratic occurrence like a war in Ukraine or China slipping into deflation). Also, during this interest rate regime, duration[34] may begin to outperform Credit, meaning that credit spreads start to widen as the economy begins to cool. In other words, investors may opt to invest in the full-faith and guarantee of U.S. government bonds (or cash) over corporate bonds, increasing their yields and thus lowering corporate bond values.

[32] A yield curve is a line that plots yields (interest rates) of bonds having equal credit quality but differing maturity dates. The slope of the yield curve gives an idea of future interest rate changes and economic activity.
[33] A dove is an economic policy position that promotes monetary policies that usually involve low interest rates, which may promote inflation.
[34] The duration of a bond is the weighted-average period of time before the cash flows involved are received. We use the term "Duration" to describe U.S. Government bonds with like maturities to that of Corporate bonds. Being that Governments typically have yields lower than Corporates, we suggest that their duration is longer, hence posing greater interest rate risk.

Exhibit 61: Interest Rate Regimes and Preferred Sector Positions



NEPCG

In a **Bull Steepener** (red-shaded area), yields on short-maturity bonds fall faster (prices increase quicker) than yields on long-maturity bonds (prices increase slower). This historically happens as the economy moves toward recession following a bottoming in economic activity and inflation prospects. During this interest rate regime, central banks may be in full rate-cutting mode, resulting in a preference for risk-free[35] duration (government bonds over corporates or high yield), with the Materials, Healthcare, and Staple sectors historically outperforming. On the downside, we typically observe Financial Services, Technology, and the Communication sector lag the overall market.

In a **Bear Steepener** regime (orange shaded area), yields on long-

[35] The term "risk-free rate" is an accepted axiom in finance describing the 10yr bond, or other "guaranteed" security backed by the full-faith of the U.S. If you buy a US bill, bond or note, you will get 100% of your principal back, so there is no principal risk. The "risk-free rate" is the basis of several financial theories but is theoretical.

maturity bonds rise faster (price falls quicker) than yields on short maturity (prices fall slower). At the beginning of this regime, the economy emerges from an economic trough, and inflation may begin to drive growth, ultimately moving toward the first rate hike of the cycle. During this period, cyclically-oriented growth sectors, including Financial Services, Industrials, and Consumer Discretionary stocks, historically tend to outperform the overall market. On the downside, underperforming sectors typically include Staples, Communication Services, and Utilities. In addition, lower-credit quality fixed-income investments usually begin to recover and outperform government and other relatively low-risk bonds.

A **Bear Flattener** Regime (the green-shaded area) historically begins with the first-rate hike of the cycle. It is characterized by yields on short-maturity bonds rising faster (prices falling quicker) than long-maturity bonds (prices falling slower). During this regime, inflation may accelerate, and the economy typically peaks. Especially toward the latter stages, cyclical-value-oriented sectors and stocks may outperform. We observe that Energy, Real Estate, and Financial sectors have historically done well, while the Materials, Staples, and the Communication Services sectors have lagged behind the overall market.

Base Case: Milder Recession = Milder Recovery…

Earlier in this report, we pointed to findings by Kevin Kliesen, suggesting that a tempered recovery typically follows a mild recession, and a more prolonged expansion paves the way for a mild recession. We also noted that the average S&P 500 return is roughly 7-8% during election years, with variations based on what party wins the White House. Also, we noted that much of the 2023 market outperformance was garnered in the last two months of the year, when investors perhaps pulled forward more aggressive rate cuts in timing and vector. Finally, we suggested that investors are seemingly "whistling past the graveyard" from a geopolitical and fundamental/economic perspective, especially during a U.S. Presidential election year.

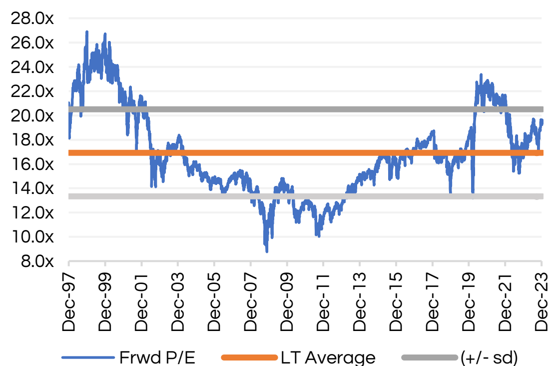
So, as we look out into 2024, we believe a good deal of forward returns have already been booked. Remember in the last two months of 2023, the S&P 500 returned almost 15%, or roughly 57% of the full-year S&P total return of 26.3%

<u>Considering the totality of our analysis and several qualitative assumptions, we estimate that the warranted fair value for the S&P (price-only) at year's end 2024 should be between 4,900 and 5,000, or roughly a 6-7% price-only return from year-end 2023 levels. However, we caveat this with two variables that may significantly influence this prognostication.</u>

First is the timing of any recession. We believe the later the recession during the year, the greater the headwind capital markets will face in meeting our year-end projection. All else being equal, we would prefer a recession to occur sooner rather than later. We would not be surprised to witness at least a 10% retracement in valuation once the capital markets accept a recession outcome; the more significant question would be timing during 2024. A recession occurring late in the year could be amplified by end-of-year tax loss selling and election dynamic fallout. This leads to our second caveat, the 2024 Presidential and related Congressional elections. As we suggested earlier in this report, the ultimate composition of government profoundly impacts equity capital markets. However, we believe the contention surrounding the 2024 Presidential election is unprecedented, fueled by a degree of emotional divide last witnessed during the Nixon era.

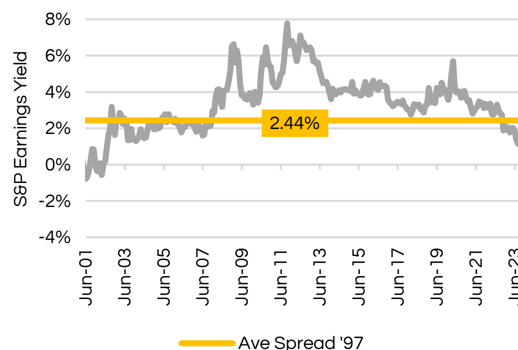
Therefore, our base-case forecast is constructed on the following assumptions: a) forward 12-month S&P earnings **<u>averaging</u>** about $265-270 per share during 2024, b) a 10-year Treasury Yield of 3.25% **<u>by year-end 2024</u>**, driving an S&P Earnings Yield Assumption of 5.75%, equating into a pre-recession multiple of roughly 17.5x, and c) a post-recession multiple premium assumption of roughly 19.5x.

Exhibit 62: S&P 500 P/E Multiple Since '97



FactSet and NEPCG

Exhibit 63: Earnings Yield Spread



FactSet and NEPCG

Therefore, we believe Defensive Growth-oriented stocks will outperform throughout 2024. Depending on the timing and vector of any potential U.S. recession. Technology may take on more "defensive value" characteristics, especially given that: 1) the overhang of the most notable bull-steepener (following the Tech Bust of 2000) is no longer a factor, and 2) the advancement/utilization of artificial intelligence in all facets of manufacturing, services and even more traditional technology- related business.

From a fixed-income perspective, we believe that markets may have pulled forward too many rate cuts in 2024, as the FOMC needs to maintain optionality. While we think rate cuts will occur in 2024, we believe that unless more dire circumstances arise, the Federal Reserve will look to delay any significant rate cuts until the second half of 2024, implying an inverted yield curve for the next several months. We believe any potential recession will not lead to an increase in corporate defaults, and hence, we doubt investors will witness a significant widening of corporate bond spreads. And while a fair amount of yield compression has already occurred, we recommend that investors use sell-offs (higher yields, lower prices) alongside Preferred Equities to extend duration in bonds with solid credit ratings. Finally, we feel that High-Yield Corporate bonds still potentially offer attractive total returns, assuming the next recession is mild.

Thank you for reading our 2024 Outlook. We'd love to hear your thoughts.

Disclosures:

The information in this publication and references to specific securities, asset classes, and financial markets are provided for illustrative purposes and do not constitute an offer to sell or solicitation of an offer to purchase any securities, nor does they constitute an endorsement with respect to any investment area or vehicle. This material serves to provide general information to clients and is not meant to be legal or tax advice for any particular investor, which can only be provided by qualified tax and legal counsel. Certain information contained herein is based on outside sources believed to be reliable, but its accuracy is not guaranteed. Investment products (other than deposit products) referenced in this material are not insured by the FDIC (or any other state or federal agency), are not deposits of or guaranteed by Northeast Private Client Group, and are subject to investment risk, including the loss of principal amount invested. Portfolios are subject to investment risks, including possible loss of the principal amount invested. In addition, foreign investments may be less liquid, more volatile and less subject to governmental supervision than in the United States. The values of foreign securities can be affected by changes in currency rates, application of foreign tax laws, changes in governmental administration and economic and monetary policy. Investors should consider the investment objectives, risks, charges, and expenses of ETFs carefully before investing. This and other information are contained in the fund's prospectus, which may be obtained from your investment professional. Please read it before you invest. Investments in ETFs are subject to risk, including possible loss of the principal amount invested. This information is being provided to current Northeast Private Client Group clients and should not be further distributed without Northeast Private Client Group's approval. S&P 500 Index is a market index generally considered representative of the stock market as a whole. The index focuses on the large-cap segment of the U.S. equities market. Dow Jones Industrial Average is a widely used indicator of the overall condition of the stock market, a price-weighted average of 30 actively traded blue-chip stocks, primarily industrials, but also includes financial, leisure, and other service-oriented firms. Russell 2000 Index measures the performance of the smallest 2,000 companies in the Russell 3000 Index of the 3,000 largest U.S. companies in terms of market capitalization. NASDAQ Composite Index is a market value-weighted index that measures all NASDAQ domestic and non-U.S. based common stocks listed on the NASDAQ stock market. Each company's security affects the index in proportion to its market value. This commentary contains forward-looking statements and projections. Actual results may differ from current expectations based on several factors, including but not limited to changing market conditions, leverage, and underlying asset performance. Northeast Private Client Group makes no representation or warranty, express or implied that this information should be relied upon as a promise or representation regarding past or future performance. This material contains the current opinions of the author but not necessarily those of Guardian or its subsidiaries and such opinions are subject to change without notice. Past performance is not a guarantee of future results. Indices are unmanaged, and one cannot invest directly in an index. Data and rates used were indicative of market conditions as of the date shown. Opinions, estimates, forecasts, and statements of financial market trends are based on current market conditions and are subject to change without notice. Securities products and advisory services offered through Park Avenue Securities LLC (PAS), member FINRA, SIPC. OSJ: 200 Broadhollow Road Suite 405, Melville, NY 11747, 631-589-5400. PAS is a wholly owned subsidiary of The Guardian Life Insurance Company of America® (Guardian), New York, NY. Northeast Private Client Group is not an affiliate or subsidiary of PAS or Guardian 2024-168138 Exp.12/24.

This material is intended for general use. By providing this content, Park Avenue Securities, LLC and your financial representee are not undertaking to provide investment advice, make a recommendation for a specific individual or situation, or otherwise act in a fiduciary capacity.