Fifth Third Institutional Services

2024 Economic and Financial Market Outlook

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Jeff Korzenik
Chief Economist
Fifth Third Bank

Thomas Jalics
Chief Investment Strategist
Fifth Third Bank
Investment Management Group

Josh Waynick
Investment Strategist
Fifth Third Bank
Investment Management Group

Note: The content in this article is based on Fifth Third's current assessment of global markets and economic signals. It reflects the same ideas shared in conversations with Fifth Third clients, but does not constitute investment advice.

Executive Summary

- **After several years of divergent outlooks, 2024 will bring economic clarity in the U.S.**
- **Our base case is that the U.S. economy is likely to experience a mild recession in 2024 as the economic resiliency of 2023 begins to fade. However, a soft landing cannot be ruled out.**
- **Labor market conditions remain the critical determinant of economic growth and inflation. The job market will dictate if a prospective downturn begins as well as its severity.**
- **The Federal Reserve has finished its tightening campaign. Markets expect an interest rate cut in the first half of 2024. We believe the Fed will remain on hold in the first half of the year.**
- **Lower interest rates in the second half of the year appear likely in our view thanks either to a recession or by evidence that inflation is firmly under control.**
- **Equity investors should remain cautious and focus on quality factors in the near-term given an uncertain economy and stretched valuations. Longer-term returns likely revert to historical mid-single digit annual averages.**
- **Fixed Income investors are the beneficiaries of higher interest rates. With economic uncertainty, investors should put an emphasis on high-credit quality issues and intermediate-term maturities.**
- **Cash remains a viable strategy given a still inverted domestic yield curve and high entrance yield. Potential interest rates cuts in the second half of 2024 are an intermediate-term risk to cash yields.**

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Setting the Table

On March 16, 2022, the Federal Reserve started raising interest rates to combat inflation. As with any monetary tightening cycle, this marked the beginning of a "race" to see which conditions would prevail first: a break in inflation or a recession. If inflation were to recede sufficiently before an economic downturn, our central bankers could hypothetically pivot to lowering rates in time to avoid a recession; this is commonly referred to as a "soft landing." Alternatively, many tightening cycles end with a broken economy – a "hard landing" of a recession. Over eighteen months have passed since the beginning of one of the Fed's most aggressive shifts in interest rates since WWII, and the U.S. economy continues to remain resilient and defy slowdown expectations. Real GDP surged to an annual rate of 4.9% in the third quarter of 2023. As of December 31, 2023, a Bloomberg contributor composite forecast expects 2.4% and 1.3% U.S. GDP growth for full years 2023 and 2024, respectively. Certainly, a recession has not materialized in 2023, nor is one currently forecast for 2024, despite a rather significant expected slowdown next year. Such economic resilience has allowed for time to bring money supply growth and supply chain problems to normalize, eliminating both sides of the "too many dollars chasing too few goods" root causes of inflation. It has been encouraging to see most broad inflation measures shift to a slower pace in 2023. For now, the "soft landing" case is winning out. But has the race been won?

Past Peak Inflation

We believe that most of the conditions that fostered inflation are diminished or even reversed as we begin 2024. Money supply growth has fallen to pre-pandemic levels, federal relief programs that stoked excess demand have passed, supply chains are healing, high mortgage rates with subsequent declines in affordability are containing home price gains, and many commodity prices are falling, leading credence to the view. While the broadest measures of inflation have shown declines, "core" measures remain outside of the Fed's comfort zone. Notably the Fed's preferred benchmark, Core PCE (Personal Consumption Expenditure) Inflation, is still averaging 3.2% annual growth, or sixty-percent higher than the Fed's 2.0% inflation target. Why does inflation persist? The most robust explanation for persistent inflation is the most obvious – a U.S. labor shortage of unprecedented magnitude.

Labor: The Skunk at the Garden Party

Ultimately, inflation is driven by a mismatch between supply and demand. The greatest imbalance in the economy is the disparity between the 8.8 million job openings in the U.S. economy and the nearly 6.3 million job seekers as of November 2023. Prior to the Pandemic, job seekers typically exceeded job openings, but the relentless math of decades of low birth rates, the early retirement of Baby Boomers, and ongoing mismatches between skills, geography and employer/employee job requirements have resulted in elevated percentages of unfilled jobs in every industry and fewer candidates than openings in every state in the Union. Various measures of wage inflation currently show wage gains hovering around 4.0% annually, much higher than typical annual wage gains of 2.0%-3.0% from 2010-2020. The labor imbalance will likely continue to keep upward pressures on wage inflation and potentially weigh down profit margins on businesses. Business owners will respond to lower profit margins by passing on higher wage costs to consumers through higher costs of their goods and services. While most measures of domestic inflation are improving, wage inflation is likely to remain sticky. Sticky wage related inflation will likely reinforce the Fed's policy of "higher for longer" interest rates. Should interest rates, and thus the cost of capital, remain elevated, economic activity is likely to moderate in 2024.

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Economic Base Case for 2024

Despite the current rosy backdrop, we remain cautious on the uninterrupted strength of the U.S. economy. Traditionally, when the Fed raises interest rates, the economy begins to grapple with a higher cost of capital. When business owners experience a higher cost of capital, typically there is less incentive to borrow and invest in their businesses, which eventually leads to slower prospective growth in cash flow and earnings. The effect of this higher cost of capital takes time before a slowdown in the real economy materializes. The time from the beginning of the tightening to the slowing of the economy historically has varied. Fed Chair Jerome Powell often refers to these of bouts of "long" and "variable" lags associated with tighter Fed Policy. Historically, slowdowns in economic activity are experienced two to three years after interest rates first begin to rise. Using this as our guide, the economy has likely not yet experienced the full effect of higher interest rates. As a result, we remain cautious on continued, uninterrupted economic strength in 2024. We continue to see room for a broad array of plausible economic outcomes over the next year. Given the persistence of the current labor shortage and wage inflation, which will likely force the Fed to keep interest rates higher for longer, eventually we should experience a slowdown in economic activity. In our opinion, the case for a soft landing remains in question. We continue to assign a 55% probability of a mild recession and a 45% probability of a soft landing in the U.S. in next 12 months.

Economic Resiliency

Our base case for a mild recession in the next twelve months is predicated on the notion that the U.S. economy is structurally more resilient than in typical cycles. Households and corporations are far less vulnerable (but not immune) to higher interest rates, compared to previous tightening cycles. Relatively few households have adjustable-rate mortgages, a sharp contrast to 2008. Household mortgage refinancing during the 2020-2022 period at historically low, fixed interest rates, has served to insulate consumers from rising interest rates. Although credit card debt has been rising, the total burden of debt payments as a percent of disposable income for consumers is near forty-year lows. A similar story is playing out in the business community as most corporate balance sheets are not susceptible to interest rate increases either as wise corporate CFOs termed out debt during the recent ultra easy money period, leaving corporate leverage levels below historical norms. Cash balances for both consumers and corporations continue to remain high offering an additional cushion. The Fed has tightened and can keep rates at today's higher levels, but outside of interest-rate sensitive segments, this sting of higher rates appears muted relative to history. Today's economy begins 2024 from a position of strength.

The Aftermath

We expect some level of clarity on the domestic economy in the coming months. Our base case is a mild recession, but we admit to the possibility that economic moderation will align with lowered inflation. Of greater interest long-term is what lies beyond that point of clarity. What will be the characteristics of the next U.S. economic expansion?

The monetary and fiscal largesse of the Pandemic masked important structural shifts in the U.S. and global economies. With central banks withdrawing liquidity and no rationale for fiscal stimulus, there will be no hiding challenges to the economy: the loss of office workers in central business districts, the shift of economic power toward workers and away from employers as the labor shortage persists, and fears over the stability of supply chains. There is no doubt that there will be economic pain associated with the incorporation of these trends. The "creative destruction" that

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underlies capitalist economies argues that new opportunities and innovative solutions will abound. We may not have yet seen widely applicable solutions to unused office space, but automation substitution for labor is already visible, and new approaches to human capital offer a chance to address pressing societal issues. Reshoring trends in manufacturing are not only re-energizing geographies with an existing industrial base, but the creation of associated career paths forces overdue reform in the education of a goods-producing workforce. History suggests that the opportunities will, over the long-term, far outweigh the challenges.

The Expected Path and Level of the Fed Funds Rate

The impact inflation will have on Fed policy remains high on the mind of investors as we enter 2024. The Fed is targeting inflation that averages 2.0% over time. The Fed's preferred measure of inflation is Core Personal Consumption Expenditures (PCE), which was 3.2% year-over-year in November 2023. Following a 25 basis point Fed Funds increase in July 2024 (target range is now 5.25% - 5.50%), the Fed has been on hold. Forecasts from the December 2024 Fed meeting suggest that the central bank has completed its tightening campaign. Investors (as measured by Fed Funds futures markets) also expect that the Fed has made its last interest rate increase and that today's rate of roughly 5.33% will be the highest terminal Fed Funds rate of the cycle. Further, investors are now expecting interest rate cuts to begin in March of 2024 with the Fed Funds implied futures rate ending 2024 at approximately 3.9%, implying six, twenty-five basis point cuts throughout 2024.

Our view is consistent with the consensus view on expectations that the Fed is finished with its tightening cycle. Where we differ from the current consensus view is that we do not see Fed Funds rate declines in the first half of 2024. Rather, we expect Fed officials to keep the expected 5.25% - 5.50% Fed Funds rate at its terminal rate through at least June of 2024, given the tight labor market's impact on inflation. One of the lessons learned from the persistent inflation experienced in the 1970s was that a lengthy period of restrictive monetary policy was needed to keep inflation levels low and steady. It is our belief that the current Fed understands this lesson and will not make the same mistake that was made during the 1970s where monetary policy was intermittently restrictive, but not restrictive enough to cure inflation once and for all. Fed Chair Jerome Powell has made it clear in public comments in December 2023 that "it would be premature to conclude with confidence that we have achieved a sufficiently restrictive stance, or to speculate on when policy might ease." A higher for longer interest rate environment will likely be necessary to cure inflation and will put the economy more at risk of a slowdown in the first half of 2024. Lower interest rates in the second half of the year are likely due to economic clarity by mid-year. Either the U.S. economy enters a recession, or investors observe clear evidence that inflation is under control and reaches the Fed's target. Both scenarios argue for lower short-term interest rates in the second half of 2024.

2024 Financial Market Outlook

We'd be remiss if we didn't ask ourselves, what is the Equity market telling us today? For the full year 2023, the S&P 500 had a total return 26.3%, the Down Jones Industrial Average was up 16.2%, and the Nasdaq was up 44.7%. The domestic equity market appears to be offering an opinion that inflation has broken before the economy has broken, the Fed has concluded its tightening cycle, and that interest rate cuts are on the horizon in 2024. The market appears to be pricing in this soft-landing, or immaculate disinflation scenario. We are hopeful that this scenario continues to unfold, but we remain cautious and a bit skeptical of the U.S. economy's ability to continue to grow without incident given persistent labor market associated inflation and a much higher cost of capital.

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We enter 2024 hitting a period where historically the “long” and “variable” lags associated with tighter Fed Policy start to affect the real economy, and we continue to experience core inflation that while improving, is running hot, driven by a tight labor market. With potential prospective economic risks in the near-term and a furious rally in the fourth quarter of 2023, equities have run a bit too far, too fast in our estimation. We recommend a neutral tactical allocation to equities relative to a client’s investment policy statement. It is too early to aggressively position for a new bull market in equities. With disparate potential economic outcomes in the first half of 2024, we expect volatility in the equity market. We advise clients not to chase the current rally which has left the S&P 500 with a 22.1x Next Twelve Months forward Price to Earnings ratio (expensive in our view). After this expected near-term volatility, we will be looking for opportunities to become more bullish and continue to hold an optimistic long-term outlook. However, longer-term prospective equity returns are likely to moderate from the torrid pace of recent years and settle into an annual mid-single digit range, consistent with long-term historical averages. This thesis is primarily supported by current valuation levels which are modestly above long-term averages and by a much higher cost of capital than investors have experienced over the past decade. These two factors argue for mean-reverting prospective returns. Entering 2024 we favor high quality (strong profitability, stable earnings, strong balance sheets, and growing dividends), shorter-duration stocks (no speculative tech), stocks that pay dividends, with a domestic bias.

For Fixed Income investors, global sovereign and corporate yields surged over the last eighteen months given persistent inflation and hawkish central banks that entered an aggressive interest rate hiking cycle. As of December 31, 2023, the ten-year U.S. Treasury bond was yielding 3.9% (versus an average of 2.2% from 2010-2021). For the first time since the Great Financial Crisis, bond investors will now earn a more reasonable yield on their investments. Most of the domestic yield curve is inverted (although much less so recently), signaling investor’s belief of an economic slowdown, a growth scare, a recession, or perhaps that inflation might moderate quickly, and that Fed policy is too tight. As economic uncertainty persists, there likely will be a ceiling on yields in the very near-term. Economic growth is likely to resume following these uncertainties. This will likely put upward pressure on intermediate global sovereign and corporate bond yields over the longer-term. Conversely, considerably lower sovereign yields continue to exist in Europe, Japan, and most of the Developed World relative to the U.S., which may push capital into U.S. Treasuries, limiting domestic interest rate increases. We maintain that these competing factors will ultimately cause global intermediate term interest rates to grind higher longer-term but limit runaway interest rate increases (yields much higher than 5.0%-5.5% on the 10-Year U.S. Treasury in 2024 appear unlikely today).

A good proxy for expected fixed income returns will likely be an investor’s entrance yield level for most fixed income subcategories. We continue to favor high credit quality, intermediate-term, domestic fixed income, as economic and inflation uncertainty persist in the near-term. Throughout 2023, parts of the domestic yield curve were inverted, arguing for a tactical position to cash relative to fixed income. In the second half of 2023, the yield curve has gone from over 100 bps inverted (as measured by the U.S. 2-Year Treasury/U.S. 10-Year Treasury yield spread) to under 40 bps inverted. We now recommend clients begin to tactically move from cash to fixed income. We recommend a neutral tactical allocation to fixed income relative to a client’s investment policy statement as we enter 2024. In other words, make your fixed income allocation look like fixed income (as opposed to very short-term fixed income or cash). One-to-five-year laddered fixed income portfolios are appropriate. Additionally, modest allocations to the Fixed Income Related category (where capital is nimbly allocated across both corporate and consumer sectors) and Treasury Inflation-Protected Security (TIPS) categories which will benefit should inflation persist are appropriate.

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Finally, allocations to Cash will help reduce portfolio volatility and preserve capital, and have become increasingly relevant, given the pickup in yield over the past eighteen months. As of December 31, 2023, money market yields are approximately 5.25%, up from essentially 0.00% in early 2022. Cash returns, or money market yields, are informed by the Federal Reserve. Our view is consistent with the consensus view on expectations that the Fed is finished with its tightening cycle. Where we differ from the current consensus view is that we do not see Fed Funds rate declines in the first half of 2024. This "higher for longer" narrative is a key theme we expect at the outset of 2024, barring a substantial slowdown in the economy. We expect cash to continue to offer compelling yields for investors as we enter 2024. Lower interest rates in the second half of the year are likely due to economic clarity. Either the U.S. economy enters a recession, or investors observe clear evidence that inflation is under control and reaches the Fed's target. Potential interest rates cuts in 2024 are a risk to cash yields.

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